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Political money contributions of U.S. IPOs☆

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ABSTRACT

We produce the first study to explore the effect of political money contributions on IPOs. Exploiting a hand-collected database, we show that both lobbying and PAC expenditure pay off on issue day as donors incur less underpricing, an effect that can be amplified by contribution size and strategic targeting of recipients. Investigating the causes in multiple channels, we also associate donor IPOs with negative offer price revisions and lower aftermarket volatility. Collectively, our results offer new empirical grounding to the information asymmetry theory.

1. Introduction

In the last week of October 2013, with barely 15 days remaining to the planned IPO, Twitter Inc. was intensifying its effort to finalize a price range for its offering. Interestingly, the firm chose this week to file its first-ever lobbying report. The issues lobbied for comprised a long agenda, mainly pertinent to consumer matters, foreign relations, technology and copyright. This expenditure came complementary to Twitter's newly formed political action committee (PAC) in an effort to reach Washington just before the company's equity reached the New York Stock Exchange. Twitter hardly pioneered the practice of political money contributions (PMC) in light of an imminent IPO. The rival social network, Facebook, initiated its own PMC within the year prior to going public, and Google, in 2004, launched lobbying campaigns in a similar time frame.

While the list of prospective issuers with a PMC record goes on, the corporate finance literature has yet to investigate an apparent paradox. The main purpose of an IPO is to raise funds for the issuing firm. The listing process itself entails substantial expenses (marketing, auditing, legal, etc.). If so, under which economic rationale would issuers engage in PMC before the IPO cash enters the corporate coffer?

In spite of the prolific literature on information asymmetries and agency conflicts in the process of going public (e.g. Beatty, 1989; Megginson and Weiss-Hanley, 1991; Carter et al., 1998; Certo, 2003; Chemmanur and Paeglis, 2005; An and Chan, 2008; Chang et al., 2016), PMC have been overlooked as a strategy to assuage this type of problems. Research centering on the interplay of business with politics mainly draws evidence from established public corporations that have developed their political

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connections over time (Faccio, 2006; Cooper et al., 2010; Ramanna and Roychowdhury, 2010; Chaney et al., 2011; Yu and Yu, 2011). Contributing to both strands of literature, this study explores the possibility that PMC contain the foremost cost of listing, IPO underpricing.[1]

A priori several lines of argument support our conjecture. First, a politically connected firm may possess bargaining power in pricing negotiations with the lead underwriter. Second, PMC are likely to structure a network facilitating information flow among the principal IPO participants. Third, access to the highest echelon of government, as a signaling mechanism, could mitigate concerns on the liquidity or price level of the new shares. Fourth, PMC may buy implicit insurance against IPO-related litigation.

To investigate for a causal effect, we assemble a unique U.S. IPO database by manually searching firms in the archives of the U.S. Federal Election Commission (FEC) and Center for Responsive Politics (CRP) for PAC and lobbying contributions, respectively. Correcting for self-selection bias, we find that lobbying, PAC and any combination of the two results in less money left on the table. The effect is of high economic significance: *ceteris paribus*, an additional 10% PMC expenditure reduces IPO underpricing by 2.5%.

To disentangle the channels leading to the inverse association, we hand-collect additional information on underwriters' PMC and IPO-related litigation. Through a series of tests, we show that underwriters value PMC clients in themselves, rather than as a means to reach their connections, and assign a higher valuation. In addition, PMC shares trade with less volatility than their non-PMC counterparts so that the appeal of an issuer's political strategy extends to aftermarket investors. By contrast, there is insufficient evidence of a networking or insurance channel.

Exploiting the traceable nature of PAC contributions, we reveal a differential effect on IPO return by type of recipient candidates. Our findings dispel the notion attaching special prestige to U.S. Senators; supporting campaigns for the House of Representatives generates a stronger effect. Splitting across party lines, we show that a Democratic bias in contributions results in the least underpricing. Finally, following Cooper et al. (2010), we construct indexes for candidate 'strength,' 'power' and 'ability.' These cross sections reveal an incremental effect for home state candidates and lengthy tenures of accomplishment as well as the need for committing to a recurring and uninterrupted PMC pattern.

In an extended sensitivity analysis, we introduce alternative time cutoffs and estimate the baseline specifications for lobbying and PAC in isolation. The need for timely contributions is highlighted. In addition, the least underpriced IPOs are shown to have employed some blend of lobbying and PAC, whereby lobbying caters for the size factor by being uncapped and PAC for the personalized dimension by entering into candidates' coffers.

Together, our findings have important implications for prospective issuers. We show how a firm's political donations, commonly associated with remote and indirect benefits, translate into an immediate and measurable gain on the IPO day. Firms which are less known to the market and vulnerable to underwriters' attempt to extract rents from underpricing could benefit substantially from PMC. Given the cash-scarcity prior to an IPO, our insight facilitates the efficient appropriation of an issuer's political budget.

This work makes several contributions to IPO and corporate finance literature addressing a topic of public interest such as the symbiotic relation between the corporate world and politics. A focal point in IPO studies is issuers' effort to overcome moral hazard and adverse selection by signaling quality. A non-exhaustive list shows issuers targeting prestige spillovers by: (1) hiring reputable auditors (Beatty, 1989), (2) inviting VCs with a proven record of successful IPOs (Megginson and Weiss-Hanley, 1991), (3) employing top-notch underwriters (Carter et al., 1998), (4) infusing management teams with prestigious executives (Certo, 2003), and (5) seeking a credit rating (An and Chan, 2008). Expanding this list, we introduce PMC as a new mechanism for attaining legitimacy. Compared to the above strategies, the advantage is likely to be twofold as: (1) with a median of $71,500, PMC plausibly entail a lower cost; and (2) the benefits are expected to extend over well beyond the IPO event.

Research on political connections mainly revolves around whether PMC constitute investment or a form of perquisites consumption (Ansolabehere et al., 2003; Aslan and Grinstein, 2012; Skaife et al., 2013). In the first work to draw evidence from IPOs, we lend support to the former framing by showing how such cash flows assist in the transition to a public domain. In this regard, our empirical evidence adds to the recent studies supporting the value-relevance of corporate political connections (Faccio et al., 2006; Fan et al., 2007; Boubakri et al., 2008, 2012; Chen et al., 2015; Chaney et al., 2011; Houston et al., 2014). Extending Cooper et al. (2010), we gauge the political and partisan preferences of market participants and show that candidate fixed effects do matter in the primary as well as secondary market. In a final contribution, we complement established PMC determinants with novel ones, tailored to IPOs, and, thus, update the studies investigating incentives for political involvement (Masters and Keim, 1985; Zardkoohi, 1985; Grier et al., 1994; Hart, 2001; Faccio, 2006).

The remainder of the paper has the following structure. Section 2 reviews selected studies of IPO and political connections literature. Section 3 develops our hypothesis. We describe our sample and contrast the two PMC types in Section 4. Section 5 outlines our methodology. The empirical analysis is in Section 6. We test the robustness of our results in Section 7. Finally, Section 8 concludes the paper.

2. Related literature

2.1. Theoretical framework

Price discovery for new equity offerings is an inherently uncertain process. The relevant literature invariably captures this uncertainty by means of listing day aftermarket performance. Since the seminal works of Logue (1973) and Ibbotson (1975) have

[1] 'Underpricing' is the prevailing jargon for the large positive returns that IPO shares typically realize on the first day of trading. Hereafter, we use the terms 'underpricing' and 'first-day return', interchangeably.