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The impact of media coverage on IPO stock performance

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A B S T R A C T

This study uses signaling theory to examine the role of media coverage on IPO stock performance. Specifically, it investigates how coverage in *credible financial media* and *the tone of media coverage* about an IPO firm before and after its listing influence its stock performance. Results show that coverage in credible financial media about an IPO firm significantly impacts its stock price. Additionally, the findings show that uncertainty in the tone of media coverage about an IPO firm adversely influences its stock price. Overall, these findings contribute to signaling theory by addressing the impact of uncertain signals on investor behavior. Moreover, the findings reported in this study also contribute to the growing organizational literature on media by emphasizing the need for scholars to examine the content of media coverage, and specifically the role of uncertain media coverage, on firm-level variables.

> "*One of the oldest clichés on Wall Street is that markets hate uncertainty and confusion.*"
> [(E.S. Browning, Wall Street Journal, September 18, 2013)]

1. Introduction

What factors influence changes in a firm's stock price after its IPO? Investors, investment bankers, the firm's managers, founders, owners (Gold, 2013), scholars in finance (e.g., Lowry, Officer, & Schwert, 2010), strategic management (e.g., Le, Kroll, & Walters, 2013), and entrepreneurship (e.g., Minardi, Ferrari, & AraujoTavares, 2013) have all sought to find answers to this question. Several studies have examined how factors such as corporate governance (e.g., Certo, Daily, & Dalton, 2001; Le et al., 2013), top management team characteristics (e.g., Liu, Li, Hesterly, & Cannella, 2012) and founder characteristics (e.g., Nelson, 2003) influence IPO performance. Although this research stream provides useful insights into the antecedents of IPO performance, these studies typically investigate factors that are at the firm level. However, investor opinions about IPOs are also shaped by factors outside of the firm such as the media (Pollock & Rindova, 2003). Therefore, scholars have started to explore how media coverage of IPO firms influences their performance (e.g., Bhattacharya, Galpin, Ray, & Yu, 2009; Pollock & Rindova, 2003; Reuer & Tong, 2010).

Although the growing stream of research that examines the influence of media on IPO performance has provided valuable insights, this literature has two important limitations. First, these studies implicitly assume that all signals coming from different media sources are equally credible; however, this assumption runs counter to the existing evidence that media credibility is an important factor that affects how investors interpret media evidence (e.g., Dyck, Volchkova, & Zingales, 2008; Kothari, Li, & Short, 2009). That is, the organizational literature on media fails to take into account the role of credibility of media, which is defined as the degree to which IPO investors perceive the media source to be trustworthy.

Second, while previous studies have examined the positive or negative tone of media coverage about an IPO firm (e.g., Pollock & Rindova, 2003), media coverage about an IPO could be neither overtly positive nor negative (e.g., Pollock, Rindova, & Maggitti, 2008). That is, media may have a neutral or an uncertain tone in its coverage of IPO firms. Yet, little is known about how uncertain or ambiguous signals influence newly listed firms' stock performance. The lack of research attention to uncertain media coverage in IPO firms can be problematic because IPO firms, due to their lack of trading history, are subject to liability of market newness (Certo, 2003). Investors may view IPO firms as more volatile and uncertain than large established firms. If the media coverage about these firms is also uncertain, it could adversely impact its stock. Although a key tenet of signaling theory is that signals reduce uncertainty (Spence, 1973; Stiglitz, 2000), the theory does not address instances when the signals themselves are uncertain.

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This study uses signaling theory (Spence, 1973) to investigate the following research question: *How does the credibility* (i.e., *trustworthiness*) *of the media and uncertain tone of the media coverage about an IPO firm influence its stock market performance?* An uncertain tone in media coverage refers to the extent to which media signals constrain the ability of investors to predict the future movements of the stock price of the IPO firm. This notion is analogous to the concept of "state uncertainty", defined by Milliken (1987).[1]

This study makes the following contributions to the literature on signaling theory and IPOs. First, we advance the organizational literature on media by investigating how uncertainty of media signals influences the stock price of IPO firms. Doing so complements previous studies that focus primarily on positive and negative signals coming from the media (e.g., Bednar, Boivie, & Prince, 2013; Pollock & Rindova, 2003; Tan, 2016). Similarly, in light of the evidence that media credibility affects investor reaction in the context of established firms (e.g., Dyck et al., 2008; Kothari et al., 2009), this study focuses on the role of credibility of media source on the stock price of IPO firms. As such, we challenge the implicit assumption in organizational literature on media that credibility of media source is a trivial factor. Specifically, the current study emphasizes the role that media credibility plays in shaping IPO firms' stock price. Second, the current study answers the call to apply signaling theory in settings other than that of large established firms (Connelly, Certo, Ireland, & Reutzel, 2011). Because media is one of the few sources that transmit signals about newly listed firms, the IPO context makes it easier to capture its role on investors' reaction. Further, although media coverage is one factor that affects investor behavior in both established (e.g., Fang & Peress, 2009) and IPO firms (e.g., Pollock & Rindova, 2003), media is likely to have an even more critical influence on IPO performance because of the lack of trading history for newly listed firms (Pollock et al., 2008). Third, unlike a majority of studies that use broad proxies to capture the role of media, such as the number of media mentions about an IPO firm (Pollock & Rindova 2003; Reuer & Tong, 2010), the current study examines the *content* of the media coverage about IPO firms. Doing so can provide a finer-grained contribution to the emerging research that examines the role of media on organizational outcomes. Fourth, a majority of studies in the literature focus on IPO firms' short-term (e.g., IPO underpricing – Filatotchev & Bishop, 2002) or long-term performance (yearly performance or survival – Minardi et al., 2013), with very little research examining factors influencing IPO performance in intermediate time frames. Even the studies that focus on intermediate IPO outcomes (e.g., Pollock & Rindova, 2003) fail to examine IPO stock performance one week after the listing date (See Moshirian, Ng, & Wu, 2010 for a notable exception). This limitation in the literature is certainly true for the strand of research that examines the role of media on IPO performance. Accordingly, this study makes an empirical contribution to the literature by examining IPO firms' intermediate performance through their stock returns one week after the IPO.

The authors chose to examine the stock return one week after the IPO date for three reasons. First, a firm completing an IPO is subject to a quiet period in which financial analysts that are affiliated with firms completing their IPOs are prohibited from issuing recommendations about them for a specified period of time (i.e., typically between 25 and 40 days after the IPO day). This means that until this period is over, underwriters or stock analysts cannot initiate research coverage on the IPO firm, thereby limiting IPO investors' access to information on the IPO firm (Bradley, Jordan, & Ritter, 2003). Accordingly, one week is a crucial period in which IPO investors would be likely to rely on media accounts to assess IPO firms' prospects. Second, Tetlock (2007) has shown that an average event that impacts investor sentiment typically reflects in the stock price the following week, but does not last beyond one week. Accordingly, in the event of an IPO, examining the role of media in stock market performance for a one-week time frame appears reasonable. Third, several popular press outlets such as *Wall Street Journal* provide investors with an IPO calendar in which there is a list of all firms that are expected to complete an IPO in the present or coming week. Accordingly, IPO investors are likely to examine the press accounts of firms publicized in this and similar websites and pay particular attention to weekly media content.

2. Theoretical framework

2.1. Media and signaling theory

How media affects organizational outcomes has received increasing interest in the literature in recent years. For example, evidence shows that media influences strategic change (Bednar et al., 2013), capital allocation decisions (Liu & McConnell, 2013), corporate social responsibility practices (Zyglidopoulos, Georgiadis, Carroll, & Siegel, 2012) and stock returns (Fang & Peress, 2009; Tetlock, 2007). Since the work of Leland and Pyle (1977) and Ross (1977), several studies have used signaling theory in IPO research (e.g., Certo et al., 2001; Khoury, Junkunc, & Deeds, 2013; Mousa, Wales, & Harper, 2014; Sanders & Boivie, 2004). This paper examines the role of media in the IPO context from a signaling theory perspective.

Grounded in economics, signaling theory (Spence, 1973) examines how information asymmetry is reduced between two parties. Information asymmetry occurs when one party possesses more or better information than the other. When information asymmetry exists, one party (i.e., the signaler) can transmit signals to another (i.e., the receiver) to reduce information asymmetry. For example, in the context of job interviews, prospective candidates use their educational qualifications to signal their ability to employers (Spence, 1973). Signaling theory asserts that individuals pay special attention to the role of costs of information acquisition processes that alleviate information asymmetries. For example, individuals are most likely to rely on reliable and low-cost signals in the presence of asymmetric information. It is important to note that Spence (1973) originally assumed control over signals from the perspective of signalers. For example, Spence (1974:1107) defined signals as "alterable observable attributes." However, in later applications of theory, several studies that use signaling theory showed that signals do not necessarily have to come from the signaler. For example, the literature shows that media, financial analysts, or other third parties often provide signals about firms (e.g., Daniel & Titman, 2006; Deephouse, 2000; Rindova & Fombrun, 1998). Similar to these studies, our focus in this study is not on signals provided by IPO firms but rather on signals provided by the media *about* IPO firms.

Although signaling theory originated in economics, it is widely used in management, particularly in the entrepreneurship literature (Connelly et al., 2011). The earlier entrepreneurship studies that used signaling theory found that entrepreneur-retained equity (Leland & Pyle, 1977) and financing strategy (Ross, 1977) can influence the perception of a firm's quality and in turn, its market valuation. Recent evidence shows that top management team legitimacy (Cohen & Dean, 2005), prestige of affiliated parties such as venture capitalists and underwriters (Pollock, Chen, Jackson, & Hambrick, 2010), and IPO social capital (Khoury et al., 2013) all serve as signals to investors about IPO firm quality.

The current study postulates that media coverage about an IPO firm serves as an important signal that investors use to form their impression about an IPO firm. There are three key rationales for this argument. First, signals sent through the media possess two characteristics that make them efficacious: observability (Goranova, Alessandri, Brandes, & Dharwadkar, 2007; Zhang & Wiersema, 2009) and low cost (Riley, 2001). Investors can easily detect the signals transmitted in the media; furthermore, advances in information technology and the internet have made it relatively inexpensive to access media reports. Both ease of observability and minimal cost of accessing signals sent through

[1] Milliken (1987:136) describes state uncertainty as follows: "Administrators experience state uncertainty when they perceive the organization environment, or a particular component of that environment, to be unpredictable".