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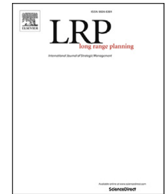

The effects of pre-IPO corporate activity on newly-public firms' growth

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ABSTRACT

We investigate firms' pre-IPO corporate activity. We find that firms involved in extraordinary – i.e., beyond momentum – amounts of acquisitions, JVs, and alliances in the year leading up to their IPOs (1) are more likely to engage in post-IPO corporate activity; and (2) enter into their first post-IPO transaction twice as fast as other firms. Our results indicate that signaling via extraordinary corporate activity can have a significant effect on entrepreneurial firms' growth. The implications are discussed.

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Introduction

Undergoing an initial public offering (IPO) is simultaneously a highly sought-after objective and an extremely demanding proposition for entrepreneurial firms. On one hand, going public raises funds at a juncture in which capital is essential to the growth and survival of firms, and it also allows entrepreneurs to capitalize on their investment and diversify their risk. On the other hand, IPOs call for fees owed to lawyers, auditors, and investment banks, all of whom help prepare the organization for public ownership. Underwriters alone demand a variable fee that hovers around seven percent of the gross proceeds in United States' IPOs (Chen and Ritter, 2000), with the total cost of going public ranging from 5.7 to 17 percent of the gross proceeds depending on the size of the offering (Lee et al., 1996).

However, it is not only financial costs that firms face, but also *opportunity* costs. For example, senior management faces significant costs in the form of the amount of time spent on helping transition the firm from private to public. As an illustration, during the marketing stage of an IPO, investment banks encourage entrepreneurs to introduce their company to institutional investors via a series of on-location presentations, otherwise known as the "road show" (Jenkinson and Ljungqvist, 2001). The IPO road show is a demanding process that lasts multiple weeks, and requires that the firm clearly articulate its strategy with potential investors—with the outcome so crucial, that a firm may even be forced to withdraw its offering if potential investors come away from presentations unconvinced of the viability of its strategy (Busaba et al., 2001). Accordingly, the top management team must weigh the benefits against the costs of going public, all during a pivotal time when resources are constrained.

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Given the significant investment in undergoing an IPO, it is plausible that firms preparing for an upcoming IPO would not want to initiate corporate activity above and beyond the pattern established in the preceding years leading up to the IPO. However, our data reveal that there is a considerable surge – well above momentum – in the number of corporate transactions entered into by firms in the period immediately preceding the IPO event. Therefore, it seems that some firms take extraordinary steps to increase their corporate activity as they near going public, which may be at odds with their need to allocate resources towards their ordinary corporate endeavors, as well as the IPO itself.

We argue that firms engaging in extraordinarily high levels of corporate activity prior to their IPO provide signals of their value to prospective partners (and also potential investors, which are outside the scope of our study), and therefore experience greater post-offering corporate growth as measured by their acquisitions, alliances, and equity joint ventures. We construct a sample of over one thousand U.S.-based newly-public firms over the years 1992–2008 and track their corporate growth activity before and after their IPO. Our results show that firms that escalate their acquisitions, equity joint ventures, and non-equity alliances prior to going public experience significantly higher corporate activity, and are more likely to engage in post-IPO deals than other firms. We also find that these firms enter into their first post-offering corporate deal twice as fast as their counterparts. These results withstand a host of robustness checks.

Substantial work has explored the effects of signaling on entrepreneurial firms' growth and competitiveness during the time of their IPOs. For example, affiliations with prominent institutional figures such as venture capitalists (VCs) and reputable investment banks affect an entrepreneurial firm's chances to be dual-tracked in M&A markets (Ragozzino and Reuer, 2007), or to form alliances after its IPO (Pollock and Gulati, 2007). Following in this work's footsteps, we do not use the IPO as a signal in and of itself, but rather as a central event to study a context where signals are used to decrease the adverse selection problem faced by prospective partners (and investors) of IPO firms, which often lack legitimacy and credibility as they transition from private to public (e.g., Certo, 2003; Gompers and Lerner, 2004; Graebner, 2009).

It is worth noting that we study the workings of signaling theory as a framework that goes above and beyond momentum theory (Amburgey and Miner, 1992; Haleblian et al., 2006). Specifically, momentum theory concerns itself with the effects of experiential learning as a predictor of future firms' actions, whereas our focus rests on the activity that lies outside of what predictable patterns firms have established over time. While we account for momentum in our investigation, we find that *extraordinary* activity plays a unique role that cannot be explained by experience. In this sense, our paper sheds light on how corporate growth strategies may be helpful in alleviating information asymmetry – which is the fundamental premise of signaling theory – and is especially salient in the context of entrepreneurial firms (Stuart et al., 1999). Accordingly, by bringing evidence of the importance of pre-IPO corporate growth activities, we contribute to the literature in corporate strategy and entrepreneurship (see Connelly et al., 2011 for a review), and show that signals issued during the pre-IPO window are consequential to the subsequent growth strategy of newly-public firms. The remainder of the paper is organized as follows: First, we lay the theoretical groundwork of signaling theory. Second, we build on the theory to develop our predictions, and then we detail our empirical design. Lastly, we present the results and discuss the implications of this work, as well as its voids and areas for future development.

Theoretical background

Information economics and signaling

The relevance of signaling theory has been discussed by scholars in economics and finance for quite some time. The theory finds its roots in the work of Akerlof (1970), Spence (1973) and Stiglitz (2002), who have received the Nobel Prize in economics for their contributions in this area. In his seminal paper, Akerlof describes the inefficiencies that arise in the market for used cars, when buyers do not hold the information needed to tell apart good-from bad-quality sellers. Under these circumstances, bad-quality sellers hold a natural incentive to misrepresent the value of their cars and for their parts, good-quality sellers cannot credibly convey the value of their cars, either. Spence (1973) uses the labor market to corroborate Akerlof's work and to underscore the importance of signaling. He argues that a job candidate can signal her value to a prospective employer by way of her educational achievements. In fact, although education may not speak directly to the candidate's capacity of performing the duties of a job, it may provide a signal of her quality, which reduces the risk of adverse selection and ultimately determines her wages.

One of the takeaways of Akerlof's and Spence's work is that without costly and observable signals – i.e., warranties on good-quality cars in the case of Akerlof's model and educational achievements in the case of Spence's model – attractive exchanges may not occur, or buyers may enter into non-value-adding exchanges, owing to adverse selection. Useful reviews of these powerful ideas can be found in Stiglitz (2002) and Connelly et al. (2011), and the significance of information economics and signaling theory has been echoed in a vast set of subsequent work (e.g., Garmaise and Moskowitz, 2004; Nicholson et al., 2005; Dewally and Ederington, 2006; Hsu, 2006). For instance, signaling opportunities have been associated with insider trading in R&D-intensive firms (Ahuja et al., 2005), firms' name changes (Lee, 2001), the appointment of new directors on boards (e.g, Certo, 2003), the characteristics of top management teams (Cohen and Dean, 2005), the choice of FDI in lieu of exports (Katayama and Miyagiwa, 2009), firms' foreign sales activity (Shaver, 2011) and many others.

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