



Underwriter deal pipeline and the pricing of IPOs[☆]



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ABSTRACT

This study examines how initial public offering (IPO) pricing is affected by the pipeline of deals in registration, measured at the underwriter level. Examining IPOs from 2002 to 2013, we find evidence that measures of the IPO bookrunner's pipeline significantly affect pricing decisions. The evidence is mostly consistent with market power and agency theories, which argue that underwriters use a young or growing pipeline to push for higher IPO first day returns.

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1. Introduction

"If there's one thing we've all learned in the aftermath of the financial crisis, it's that stiffing your client is not a crime. Not if you're an investment bank." – Joe Nocera commenting on the first day return following LinkedIn's initial public offering (New York Times, 2011).

Research on initial public offerings (IPOs) has long recognized the significant impact that underwriters have on deal pricing. To measure this impact, early studies include measures of underwriter reputation such as Carter-Manaster ranking (Carter and Manaster, 1990) or underwriter market share (Megginson and Weiss, 1991) as

independent variables in models of IPO first day returns. The initial evidence was consistent with theories, such as the Booth and Smith (1986) certification theory, arguing that underwriters play a positive role for issuers in reducing first day returns. In the late 1990s, findings about the relation between underwriter reputation measures and IPO first day returns became mixed, with several studies showing a positive effect (e.g., Beatty and Welch, 1996; Cooney, Singh, Carter, and Dark, 2001; Logue, Rogalski, Seward, and Foster-Johnson, 2002). These findings are more consistent with agency theories (e.g., Baron, 1982) arguing that underwriters play a negative role for issuers in pushing for higher first day returns.

Some researchers recognize that endogeneity makes interpretation of the evidence problematic. If common factors affect issuer choice of underwriter (or, alternatively, underwriter choice of issuer) and first day returns, then ordinary least squares first day return regressions including underwriter reputation measures, observable when an underwriter is selected, as independent variables could

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be biased. Some have responded by using econometric techniques that model endogeneity (e.g., Benveniste, Ljungqvist, Wilhelm, and Yu, 2003; Fernando, Gatchev, and Spindt, 2005). A challenge for this research is that inferences are based on joint hypotheses that certain relations hold between underwriter reputation and first day returns, and that the researcher has identified the correct structural econometric model.

We add to the literature by introducing several new measures to capture the role of underwriters in IPO pricing. These measures have two significant benefits. First, distinct predictions regarding the impact of our measures on pricing emerge from competing theories. Second, the new measures are constructed in such a way that endogeneity is not a significant issue. The primary measures focus on the pipeline of deals that have been initiated [i.e., registered with the Securities and Exchange Commission (SEC)] but are not completed or canceled that are led by each issuer's underwriter. For each IPO, we identify measures related to the change in total capital in the pipeline being managed by the issuer's bookrunner(s). Separate measures are constructed for intra-industry (same industry as the issuing firm) and extra-industry (all other industry) issues in the bookrunner's pipeline. We measure pipeline changes over two periods, one leading up to the first pricing date for the IPO but after its initial filing and one between the first pricing date and issuance.¹ We also introduce measures of the average calendar days in registration of a bookrunner's pipeline as of the first pricing date for the IPO (days between the filing date for each IPO in the pipeline and this IPO's first pricing date). Separate measures are constructed for intra-industry and extra-industry offerings in the bookrunner's pipeline. Our pipeline variables are noteworthy in that they are unobservable when an underwriter is selected and, thus, endogeneity should not be a concern.²

An examination of the impact of underwriter-level pipeline measures on IPO pricing can be motivated by several theories. Some theories posit a positive role for underwriters in facilitating lower first day returns for issuers. Benveniste, Busaba, and Wilhelm (2002) suggest that underwriters can reduce required first day returns by pooling offerings subject to a common valuation factor (frictions are reduced as information learned in one offering can be applied to others). Thus, changes to an underwriter's dollar pipeline (especially the pipeline of intra-industry deals) should be negatively related to IPO first day returns. Pipeline calendar days in registration should be positively

related to first day returns, as an aging pipeline should make it more challenging to pool (information in stale offerings is less relevant).

Other theories posit a less positive role for underwriters in IPO pricing. In the Khanna, Noe, and Sonti (2008) model, when underwriters become overextended (because of a growing pipeline), their ability to effectively screen and market deteriorates and first day returns for IPOs managed by these underwriters increase. Other theories argue that underwriter market power relative to issuers is positively related to deal frequency (Liu and Ritter, 2011). Given agency conflicts arising from an underwriter's preference to reduce effort (Baron, 1982) or benefit from soft dollar commission revenue (e.g., Reuter, 2006; Nimalendran, Ritter, and Zhang, 2007; Goldstein, Irvine, and Puckett, 2011), underwriters with more market power should push for higher first day returns. Underwriter capacity, agency, and market power theories, therefore, predict that changes to an underwriter's pipeline should be positively related to IPO first day returns. Agency and market power theories predict a negative relation between pipeline calendar days in registration and first day returns, as market power arguably decreases with the calendar days in registration of an underwriter's pipeline. Underwriter capacity theory predicts a positive relation between pipeline calendar days in registration and first day returns, as an aging pipeline can be more challenging for an underwriter to market.

We examine the impact of an underwriter's pipeline on pricing for IPOs between 2002 and 2013. Measurement of the value of an underwriter's pipeline requires hand-collection of data from initial prospectuses from the SEC Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system database. We start our analysis in January 2002 to exclude the unusual dot-com bubble period (from January 1998 to June 2001) with its extreme issue characteristics (Ljungqvist and Wilhelm, 2003; Loughran and Ritter, 2004), dubious (and, in some cases illegal) practices (Hao, 2007; Liu and Ritter, 2010), and significant regulatory change [e.g., Regulation Fair Disclosure (Regulation FD) in 2000 and the Sarbanes-Oxley Act in 2002; see Gao, Ritter, and Zhu (2013)]. Our base analysis, therefore, focuses on the post-bubble period, which is likely to be more relevant to understanding the general (and current) role of underwriters in IPO pricing.

Underwriter-level pipeline measures significantly impact IPO pricing. The explanatory power of pricing models improves when pipeline variables are included. Our evidence is mostly consistent with agency and market power theories, which argue that underwriters play a negative role in pricing. Changes to a bookrunner's later filing period intra-industry pipeline significantly positively affect IPO first day returns, consistent with both underwriter capacity, agency, and market power theories. Bookrunner intra-industry pipeline calendar days in registration significantly negatively affects first day returns, which is consistent only with agency and market power theories, however. No significant evidence indicates that underwriters use a growing pipeline to push for lower IPO first day returns. The impacts of our new pipeline variables on first day returns are economically large. From 2002 to 2013, issuers in our sample raise approximately \$204

¹ When an IPO is initially filed with the SEC, the issuer generally does not specify the number of shares expected to be sold or a bona fide range of prices. Instead, it simply indicates the maximum capital expected to be raised. Our pipeline size variables focus on the maximum proceeds in registration to ensure consistent measurement through the registration process. We are careful to distinguish between the filing date (the first date the IPO is registered with the SEC) and the first pricing date [the date on which the issuer first files an amendment to indicate valuation-relevant information, including the number of shares to be sold and a high and low initial (first) pricing range].

² When an underwriter's pipeline is unusually low or high at the filing date some change may be expected. We address this and other endogeneity concerns in Section 4.2.

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