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Market conditions, underwriter reputation and first day return of IPOs

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Abstract

In this study, I develop a model that describes underwriters' price-setting behavior during initial public offerings (IPOs). Because of reputational concerns during high valuation periods, top-tier underwriters adjust the initial offer price valuation to the lower, historical industry valuation. The top-tier underwriter effectively increases the first day return but decreases the long-run underperformance of the IPO. In contrast, low-tier underwriters price issues to maximize cash flow. The empirical findings support the model. The first day return is significantly correlated to the relative valuation, and reputational concerns are only important to top-tier underwriters.

JEL classification: G24; E32

Keywords: Investment banking; Underwriter reputation; Initial public offering; Industry valuation; Underpricing

1. Introduction

In May of 1997, Amazon.com, Inc. issued its first public stock and on the first trading day, the stock value increased by 30.6%. As researchers, we have long examined the causes for the significant first day return of initial public offerings (IPOs). It seems paradoxical that firms that undergo the IPO process and are presumably in need of capital for investments would be willing to leave significant amounts of cash on the table. Many hypotheses have been examined including the winner's curse hypothesis by Rock (1986) and the lawsuit avoidance hypothesis

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described by Tinic (1988), Hughes and Thakor (1992), and Drake and Vetsuypens (1993), among others. I add to the understanding of IPOs' first day returns and underwriters' pricing strategies and identify an ex-ante variable, the current industry P/E scaled by historical average, that significantly affects the first day returns of IPOs.

During Amazon.com's issuance month, the mean price-to-earnings ratio in the computer software industry was 43.7; this was 89% higher than the 10-year historical average of 23.1. This study examines how this disparity between the current and historical industry valuation affects the first day return. I assert that top-tier underwriters have greater reputational concerns and will minimize the long run underperformance. The top-tier underwriter will adjust the initial offering price toward the historical value. In contrast, low-tier underwriters have less reputational concerns and price the initial offer to maximize current cash flow. The consequence of this pricing strategy is that, for issues underwritten by top-tier underwriters, the first day return relates with the overvaluation relative to historical values. However, for low-tier underwriter issues, the relative industry valuation is not related with the first day return.

In this study, I examine three main strands in the underpricing literature. The first strand of literature is the maximization of proceeds by the firm and underwriters. Many studies have examined why the firm and the underwriter would be willing to accept large underpricing. Some of these studies examine firm characteristics and their association with the first day return. Allen and Faulhaber (1989) and Garfinkel (1993) show that the first day return is a signal of the quality of the firm. They find that investors see underpricing as a credible signal of quality because high-quality firms can recover the losses from underpricing in subsequent offerings. Ritter and Welch (2002) also argue that the allocation of shares in the primary market may significantly affect the first day return and indeed, Loughran and Ritter (2004) confirm that the increase in the first day return is due to the underwriters spinning shares to other clients. Thus, it seems possible that the price being set by the underwriter and the firm is not necessarily to maximize the cash flow from the issuance, but rather future cash flows.

The second strand of literature is the role of the underwriter reputation on the first day return. Many studies have examined the role of the underwriter in the first day returns, including Carter and Manaster (1990), Beatty and Welch (1996), Carter, Dark, and Singh (1998), and others. They find that underwriter reputation is an important determinant in the first day return, although Beatty and Welch (1996) find that the relationship significantly changes after 1990. Loughran and Ritter (2004) show that the increase in the first day return during 1999–2000 is due to a change in the objectives of the underwriter and firm, mainly the increased spinning by underwriters.

The third strand of literature is the impact of the prevailing conditions during the issuance and the impact on the first day return. Ritter and Welch (2002) document time-period variability in the number of IPOs and the first day returns. Baker and Wurgler (2000) show that equity is predominantly issued during excessive valuations and after periods of high equity issues the mean market returns the year after are significantly lower. Additionally, studies have shown the effect of the IPO firm's valuation relative to its industry. From a large Italian dataset, Pagano, Panetta, and Zingales (1998) show that firms are more likely to go public during high industry market-to-book ratios. Purnanandam and Swaminathan (2004) argue that the IPO may actually be overvalued based on the “true pricing” relative to similar firms in the same industry. They show that firms that are overvalued relative to their industry peers suffer long run underperformance. Ljungqvist, Nanda, and Singh (2006) develop a model where the primary investors are compensated by the first day return for the unpredictable drop in market value. Campbell, Du, Rhee, and Tang (2008) document higher price-to-value ratios for IPOs during