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Underwriter reputation and IPO issuer alignment 1981–2005☆

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ABSTRACT

We examine the long-term performance and characteristics of firms that went public from 1981 to 2005. We find that long-run returns declined and the proportion of failed and failing firms increased with underwriter reputation. The IPOs marketed by the more reputable underwriters were more likely to fail or be failing in the post-1980s period, but were still better than those of less reputable counterparts. The characteristics of the firms marketed by the more reputable underwriters did not appear to change substantially from decade to decade. We conclude that external market forces rather than conscious changes by underwriters caused the shift in the relation between failure rates and underwriter reputation from the 1980s to the subsequent period. We also find the "flip" in relationship between underwriter reputation and initial IPO return identified in the literature disappears after controlling for additional factors.

1. Introduction

What is the relation between underwriter reputation and the subsequent performance of firms the underwriters bring to market through equity initial public offerings (IPOs)? This question is interesting because of several developments over the past 25 or 30 years. Lowry and Schwert (2002) document that initial IPO returns have risen from about 7% in the 1980s and early 1990s to as high as 65% by 1999–2000. Carter and Manaster (1990) and Johnson and Miller (1988) find that in the early 1980s the relation between underwriter reputation and the initial return to IPOs was negative. Yet Beatty and Welch (1996) document a reversal in this relation in the early 1990s.

In the longer term IPOs have been shown to underperform (Ritter, 1991; Loughran & Ritter, 1995). However, the evidence relating longer-term performance to underwriter reputation appears mixed. Carter, Dark, and Singh (1998) report a positive relation between underwriter reputation and long-term returns, while Logue et al. (2002) report no relationship.

In this research we investigate the relation between underwriter reputation and the characteristics of IPO firms and their performance from 1981 to 2005 to identify longitudinal changes and, if they exist, to estimate the magnitude. For comparison purposes we separate the sample into two sub-periods for much of the analysis: 1981–1990 (EARLY) and 1991–2005 (LATE). We find that long-term IPO returns have significantly declined from EARLY to LATE periods for both raw returns and matched firm-adjusted returns. We also find that the proportion of failed and failing firms has significantly increased. These firms tend to be unlisted, younger, have lower revenues and net income, and are riskier in terms of the standard deviation of after-market return. All of the characteristic variables for failing firms increased from EARLY to LATE periods with the exception of return on assets and the age of the firm at the IPO.

While we find that reputable underwriters maintained a positive relationship with better performing firms, it was not as distinct and definitive in the LATE period as it was in the EARLY period. However, there was little change in the types of IPOs the more reputable underwriters marketed from EARLY to LATE periods. A surprising result is the maintenance of the negative relation between underwriter reputation and initial return from period to period. This is counter to evidence by Beatty and Welch (1996) and others and can only be reconciled by our inclusion of additional variables which more accurately reflect changing market conditions.

The remainder of the paper proceeds as follows. In the next section we briefly outline previous research and the importance of

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the current work. In Section 3 we describe the data and in Section 4 the methods and results. Section 5 contains robustness checks and Section 6 outlines our conclusions.

2. Background

There are a number of significant developments that occurred in markets during the 1980s through the early 2000s that have a bearing on our research. Besides the changes in initial IPO returns mentioned above, the number of new firms listing on major U.S. stock markets from 1980 through 2000 increased by 244% (Fama & French, 2004). Fama and French report that during this 20-year period, "profitability becomes progressively more left skewed and growth becomes more right skewed" and that the firms that went public became "weaker" with a subsequent decline in survival rates. If fledgling firms became generally riskier over the period of study it would be increasingly more difficult for investment banks to choose firms commensurate with their reputation.

The number of venture capital-backed IPOs dramatically increased in number (Black & Gilson, 1998) and it is likely that underwriters deferred to venture capital for screening (Chemmanur & Loutskina, 2005). Underwriters also began to shift their focus over the period. At the end of the 1980s underwriters began to face competition from banks for new equity underwriting while activity in more lucrative acquisitions and buyout markets began to increase. As a result, investment banks looked to IPOs less for establishing long-term relationships and more for generating quick profits and *quid pro quos* for long-established associations with institutional investors (Humphrey, 1989).

There were also two important events occurring during the 25-year period that may have shaped changes in IPO markets. The first of these was the 1987 stock market crash, after which investors began to demand more screening on the part of the underwriter (Khanna, Noe, & Sonti, 2005). Should this become too costly, underwriters must look for alternative means to establish relationships. The second event is the "dotcom bubble," a period of persistent price increases for stocks of participating industries, followed by a dramatic fall in stock prices that lasted until September of 2002. Ljungqvist and Wilhelm (2003) identify this bubble period as 1999 and 2000. Anecdotal evidence of illegal profit sharing from hot IPOs between underwriters and buy-side clients, which may also be a factor in recent developments, is provided in various U.S. Securities and Exchange Commission (SEC, 2002) press and litigation releases on investigations of IPO allocation practices.[3] While Fernando, Gatchev, and Spindt (2005) argue and provide evidence that firms' and underwriters' characteristics are positively related, there is a distinct possibility that during this period the pursuit of ephemeral profits interfered with the matching process.

Related theory is generally concerned with the matching of underwriter reputation to issuing firms with particular characteristics and what that may convey to the market. While Hayes (1971) describes the components of investment bank reputation in some detail, reputation has been empirically defined primarily by proxies. The two most common of these are a ranking based on the underwriter's placement in tombstone advertisements and the investment bank's relative market share in IPOs (see Carter and Manaster (1990) and Megginson and Weiss (1991)). On the firm side, characteristics such as age and revenue are used to reflect the issuing firm's potential risk and return (Ritter, 1984). Carter and Manaster (1990) and Johnson and Miller (1988) show that reputable underwriters market the IPOs of less risky firms.

Beatty and Ritter (1986), Booth and Smith (1986), and Titman and Trueman (1986) suggest that underwriters signal the underlying risk of their IPOs with their reputation while Beatty and Ritter and Carter and Manaster provide theory that relates IPO returns to the signal.[4] But these signaling arguments require a consistent alignment between the reputation of underwriters and the characteristics of their IPOs. If there is not, then any signal from reputation unravels. We believe that changes in financial markets and participants over the last 25 years may have changed the relation between underwriters and issuing firms and that an underwriter reputation signal is no longer valid or at least different than it was 25 years ago. Hence a major objective in this study is to test whether the alignment of underwriter reputation and the characteristics of the firms they market have changed over the last two and a half decades.

With long-established reputation at stake as well as skill in assessing the intrinsic value of issuing firms, it is logical that, while prestigious underwriters may have relinquished some integrity to buy-side clients in the 1990s, they would still be less susceptible to pressure to market questionable IPOs than less reputable investment banks. However, some distinction between the IPOs of prestigious and less prestigious underwriters may have faded. Our purpose is to analyze the relation between the reputation of underwriters and the characteristics of their IPOs from 1981 to 2005 in an attempt to identify longitudinal changes. Significant changes over the period would suggest that signaling models linking reputation to issuing firms may no longer be valid.

3. Data

We assemble the sample from the Thomson Financial SDC database. We remove unit offerings, financial institutions, closed-end funds, REITS, limited partnerships, stocks with offering prices of less than $2, and stocks without CRSP returns, leaving a total sample of 6686 domestic IPOs. Variables extracted from the SDC database include the underwriters managing the offering, the lead underwriter, the pre-offer price range, the final offer price, the date of the offer, venture capital participation, the SIC code, the number of shares offered from the firm and from the personal holdings of pre-IPO owners, and where, if at all, the firm has been listed.

We use an adjusted Carter and Manaster (1990) underwriter reputation ranking. The ranking is independent and separate for each of five, 5-year segments of our study. The rankings from Carter and Manaster (1990) and Carter, Dark, and Singh (1998) form the basis for the 1981–1985 and 1991–1996 periods, respectively. We estimate our own set of rankings for the remaining periods (1986–1990, 1995–2000 and 2001–2005) using offering tombstones and underwriter prospectus listings issued during the respective periods following the algorithm described in detail in Carter and Manaster (1990). These raw figures are then multiplied by the average offer price of the IPOs the underwriter marketed during each period, dividing the product by 100. As Loughran and Ritter (2004) point out, a potential flaw in the Carter–Manaster methodology is that penny stock underwriters that are never allowed to participate in a syndicate of prestigious underwriters might never be assigned low Carter–Manaster ranks.[5] While we have no consistent penny stock underwriters in our sample, Loughran and Ritter (2004) and Fernando, Krishnamurthy, and Spindt (2004), make compelling arguments for the importance of offering prices in defining the relationship between IPO and under-

[3] For example, see SEC Litigation Release No. 17327: http://www.sec.gov/litigation/litreleases/lr17327.htm.

[4] Allen and Faulhaber (1989), Grinblatt and Hwang (1989) and Welch (1989) provide a different approach but the fundamental premise is signaling nonetheless.

[5] Fernando et al. (2004) find that underwriter reputation is greater at higher price levels.