Video
Lecture

IPO underpricing

Advanced Financial Management

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IPOs costs

Direct Costs

The underwriting spread:

- The underwriting spread is the fee paid by the firm to the underwriters.
- Typically this about 7% of the issue price.

Costs due to IPO underpricing

- IPOs issue prices tend to be below the closing price on that day.
- The difference between closing price and issue price is lost by issuers.

Empirical evidence on IPOs

Short-term returns:

- Day 1 returns average 16%
  - i.e. Day 1 closing price is on average 16% higher than the IPO price
  - Indicates underpricing: Firms could have sold the shares for 16% more.

- Returns are risky
  - Returns vary widely by year (1960-1987)
  - The worst year was 1973 when IPOs returned -18%
  - The best year was 1968 when the return was +56%

Empirical evidence on IPOs

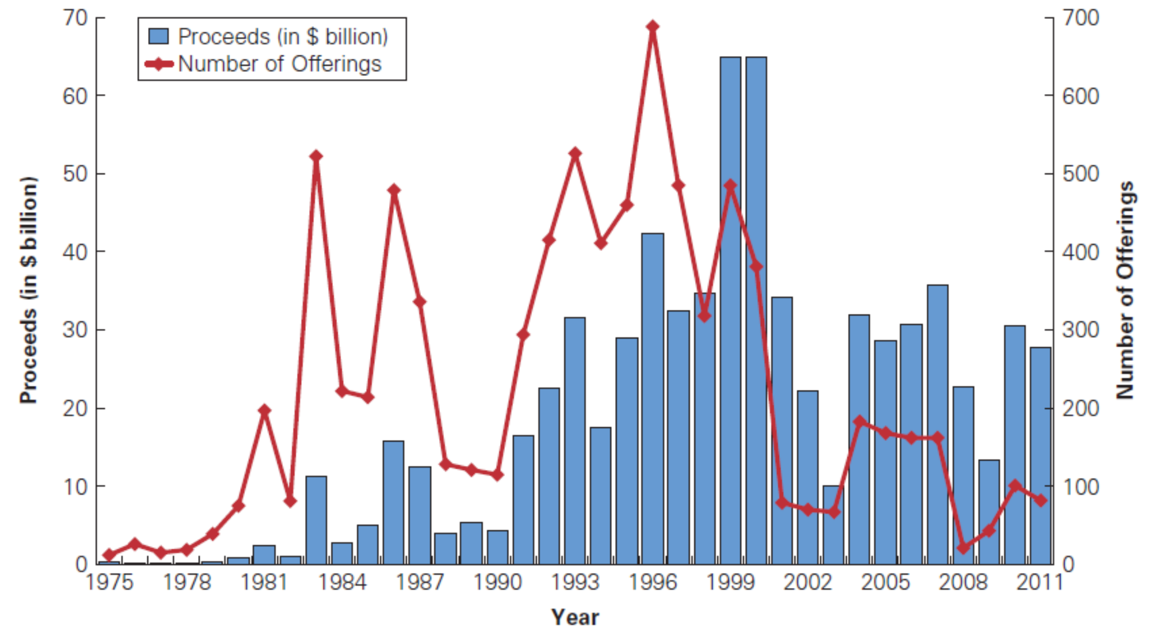
Short-term returns:

- Underpricing varies with uncertainty about the stocks value
  - Larger firms are underpriced less. Firms with sales less than $1M when they go public had initial excess returns of 31%.
  - Firms with sales exceeding 25M had initial excess returns of only 5%
  - Underpricing is smaller for older firms.

- International results similar
  - Not just a US phenomenon. Underpricing occurs in every country with IPOs.
  - Smaller issues are again underpriced more than bigger issues

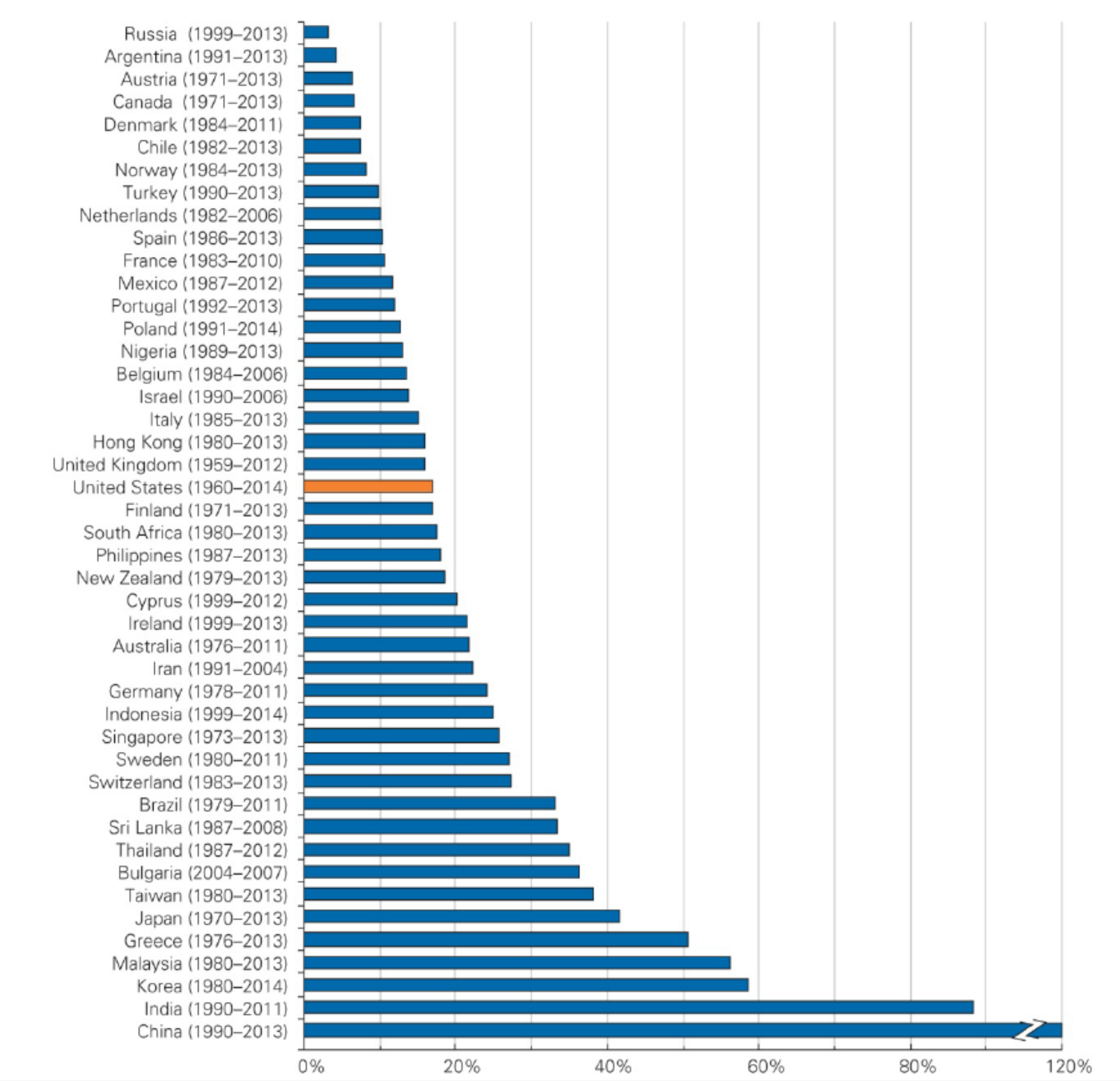
Empirical evidence on IPOs

- IPO activity is cyclical (comes in waves).This should not be surprising:
  - There should be greater need for capital in times with more growth opportunities than in times of fewer growth.
- Long-run returns are low:
  - Poor relative performance in the subsequent 3-5 years



Average first day IPO returns

- Who benefits from underpricing?
  - Underwriters by controlling their risk
  - Investors who buy the stocks
- Who looses?
  - Pre-IPO shareholders of issuing firms.



Why are IPOs underpriced?

- Underwriter price supports
  - Underwriters can support the price of an IPO by buying shares at IPO price or lower
- Benefit the underwriter
  - Favors for the clients of the underwriters
- Risk averse owners
  - Once-in-a-lifetime very positive NPV project
- Information asymmetry (Winner's curse)
  - Form of adverse selection: an auction's winner (i.e. the highest bidder) may have overestimated the object's value
  - You win (get all the shares you requested) when demand for the shares by others is low and the IPO is more likely to perform poorly.
  - We need all types of investors to buy the shares of an IPO, otherwise there may not be enough demand for the issues.

Winner's curse: intuition

Assume that, on average, your estimate of the value of a firm is correct and you are an uninformed investor (that is, you cannot distinguish between the good and bad deals):

If you bid at your estimate, then:

If IPO is a good deal

- Informed investors know the deal is good and want to subscribe to the deal.
- Uninformed investors also want to participate.

The deal is over subscribed. You receive a small (or no) allocation

If IPO is a bad deal

- Informed investors know the deal is bad and withdraw.
- Uninformed investors subscribe to the deal.

The deal is under subscribed. You receive a large allocation

On average, when you `win' in the IPO share allocation, which it's more likely to be a bad IPO (`winner's curse')

⇒ Bidding strategy: In order to break even, you bid at a discount.