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Recommended Citation
Available at: http://digitalknowledge.babson.edu/fer/vol30/iss1/4

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SUMMARY

IPO UNDERPRICING, THE PERSPECTIVE OF THE ISSUING FIRM: MONEY LEFT ON THE TABLE OR STRATEGIC ACTION?

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Principal Topic

Why are the vast majority of initial public offerings (IPOs) underpriced? We show that firms can have strategic reasons to underprice more than necessary. Most importantly because the first trading day share price increase that is the result of underpricing enhances the public recognition of a firm and can be used to attract critical stakeholders such as skilled workers and customers.

Although underpricing is well researched, a handful of contradictory explanations for it exist (Daily et al., 2003). Previous explanations have been primarily based on the assumption that raising funds is the driving force behind a firm’s intention to go public (Daily et al., 2003). These existing explanations interpret underpricing as a cost of going public -- it lowers the proceeds from the IPO. However, in this paper we highlight that underpricing is not just about attracting capital it can also play an important role in the attraction, not of shareholders, but of other important stakeholders.

Like most actions a firm undertakes, an IPO is a strategic decision (Draho, 2004), and it has substantial effects on a firm’s position in its environment and on its relationship to important stakeholders. We argue that the anticipation of these effects influence the going public decision, and that firms use underpricing strategically to enhance the magnitude of such non-financial IPO effects. Specifically underpricing defined by the first trading day share price increase affects the way a firm is perceived by potential future stakeholders -- it increases a firm’s visibility, and as a result, a firm’s perceived transparency and reputation; this in turn helps a firm to attract important stakeholders such as skilled employees and customers.

We hypothesize that the more a firm wishes to attract such stakeholder the more it will choose to underprice its IPO. However, since it can be argued that the underwriter of an IPO plays the primary role in setting the IPO price firms might not have much ability to directly influence IPO underpricing. Instead the paper shows that firms affect their level of underpricing through their choice of underwriter.

Method, Results and Implications

We test our hypotheses with large-sample archival data of 800 IPOs including an analysis of hand coded IPO prospectuses that allows us to control for firm quality. Overall, results from our analysis support our hypotheses, highlighting how strategic considerations play a role in underpricing and underwriter choice.

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