SOURCES OF INFORMATION ASYMMETRY AND UNDERPRICING IN INITIAL PUBLIC OFFERINGS (SUMMARY)

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VENTURE CAPITAL

SUMMARY

SOURCES OF INFORMATION ASYMMETRY AND UNDERPRICING IN INITIAL PUBLIC OFFERINGS

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Principal Topic

In a typical IPO, a new venture floats its shares of stock through an underwriter. The underwriter offers the shares to a group of institutional investors and any leftover shares are sold on the market on the first day of trading. It is common for the IPO shares to suffer underpricing which is the difference between the offer price of the stock and its higher closing price on the first day of trading. Underpricing is enabled by information asymmetry; those who sell the shares know more than those who buy the shares. More importantly, this information asymmetry is exacerbated because the IPO process is a mediated market. Since the underwriter is a middle party to the ultimate exchange of shares, the information asymmetry facing underwriters affects the amount of underpricing. In this paper we identify when information asymmetry will be higher or lower for the underwriter and then we examine whether this has an impact on the amount of underpricing. More specifically, we hypothesize that when a new venture utilizes a greater proportion of technology from outside the industry, it will pose pricing difficulties for the underwriter. However, when an underwriter has more experience underwriting shares of companies from the same industry, this experience will reduce its information asymmetry for the underwriter and lead to lower underpricing.

Method

We test our hypotheses on a sample of new ventures going through the IPO between 2001-2005 and identify the proportion of their technology from outside the industry based on patent citations. We also identify underwriter experience (underwriting IPOs in the focal industry). Our dependent variable is the amount of underpricing. Hierarchical regression is used to test the hypotheses.

Results and Implications

We find that higher information asymmetry for the underwriter leads to higher underpricing but experience in the industry does not reduce the underpricing. In fact, the interaction between extra-industry technology and underwriter experience in the industry is positive and tends to indicate that underwriters may exacerbate the amount of underpricing in certain situations possibly to benefit themselves at the expense of IPO firms.

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