

Module 2

Corporate Financial Decision-Making for Value Creation

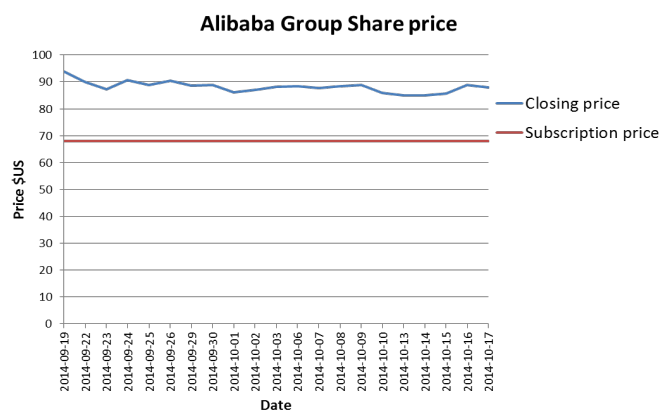
Raising Equity Capital 2: IPO Underpricing (Leaving money on the table...)

Presenter: Sean Pinder



Setting the scene

Recall that the Alibaba Group set its *subscription price* at \$68 the day before they listed on NASDAQ ...



... they closed the first day at \$93.89.

Underpricing defined

One interpretation of systematically setting the subscription price for an IPO below the “true” value of the shares is that the IPO was **underpriced**.

IPO underpricing is measured as:

$$\text{Underpricing} = \frac{\text{First day closing price} - \text{Subscription price}}{\text{Subscription price}}$$

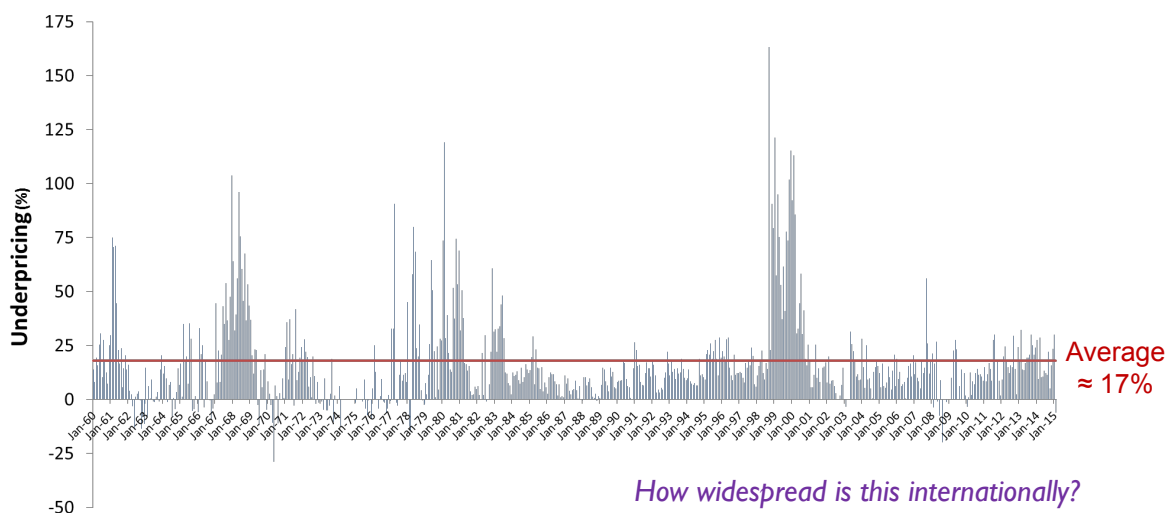
... so for Alibaba we have:

$$\text{Underpricing} = \frac{93.89 - 68}{68} = 38.07\%$$

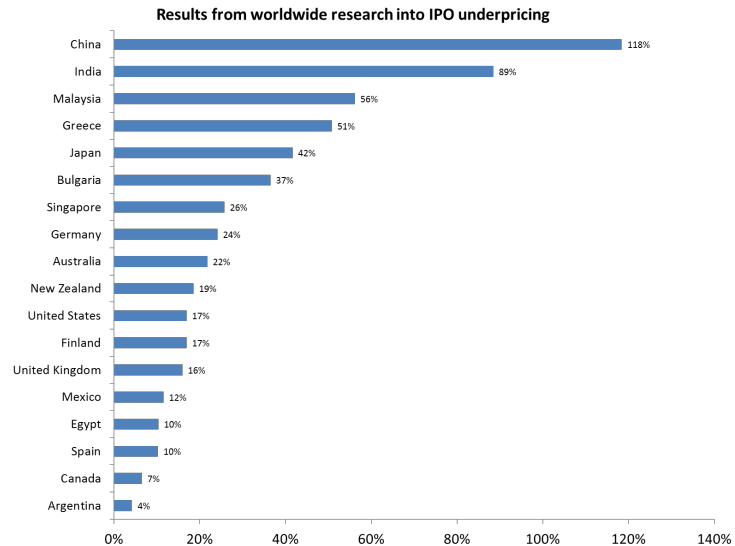
Is this a “one-off” situation?

Evidence on IPO underpricing

Average first day underpricing: US market (by month)



Evidence on IPO underpricing



Reasons for IPO underpricing

1. Information asymmetry and the “Winner’s Curse”

Imagine that investors come in two categories:

- i. **Informed Investors** – able to judge whether an IPO is over or underpriced
- ii. **Uninformed Investors** – not able to judge whether an IPO is over or underpriced.

As each IPO comes to the market – *who is going to bid for overpriced IPOs?*

Who will succeed in getting shares in underpriced IPOs?

To ensure that uninformed investors stay in the market – IPOs need to – on average – be significantly underpriced.

Reasons for IPO underpricing

2. Investment banker monopsony power

Recall your coffee-delivery service that was going to IPO.

The first step was to engage an investment bank. The banker/underwriter will advise on subscription price.

This creates a potential conflict for at least two reasons:

1. Underpricing can reduce their own costs
2. Underpricing can be used (unethically) to develop relationships with other potential clients
 - this is a practice known as *IPO spinning* and is illegal in many jurisdictions.

Reasons for IPO underpricing

3. Lawsuit Avoidance and implicit insurance

The prospectus is (partly) a marketing document – so there is a chance that perhaps some of the forecasts might be a little... biased... ahem...

Underpricing ensures that subscribers enjoy a gain from investment.

Management have essentially purchased *implicit insurance* ... But who has paid for it?



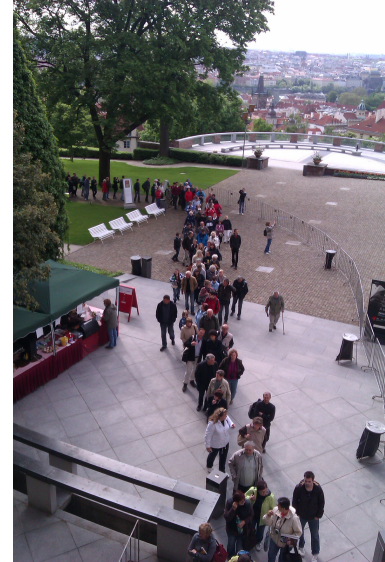
Reasons for IPO underpricing

4. Signaling as part of a longer term strategy

As CEO – you know that the IPO is only the next stage in a multi-stage strategy for expansion.

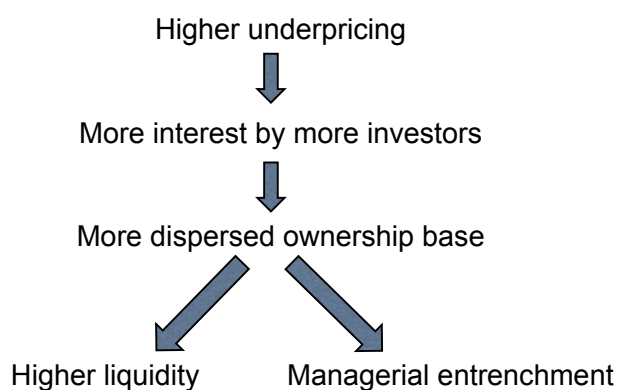
You know that in the future you will have to go back to the market to raise more capital.

By underpricing this time – you can leave a “good taste” with investors ...



Reasons for IPO underpricing

5. Ownership dispersion



Summary

IPO underpricing occurs where the subscription price for a float is set below the true market value of the shares.

IPO underpricing is a world-wide phenomenon that has been documented over an extended period of time

– *this is not to say that every IPO is underpriced!*

Reasons for IPO underpricing include:

1. Information asymmetry and the “Winner’s Curse”
2. Investment banker monopsony power
3. Lawsuit avoidance and implicit insurance
4. Underpricing to leave a “good taste” with investors
5. Ownership dispersion.

*So we have considered raising equity capital via an IPO –
now what about debt...?*

Source list

Slide 2: Alibaba Group Share Price. Graph prepared by Sean Pinder from data sourced from www.NASDAQ.com. © The University of Melbourne.

Slide 4: Average first day underpricing: US market by month. Graph prepared by Sean Pinder from data sourced from IPO Data, Warrington College of Business Administration, University of Florida (<http://site.warrington.ufl.edu/ritter/ipo-data/>). © The University of Melbourne.

Slide 5: Results from worldwide research into IPO underpricing. Graph prepared by Sean Pinder from data sourced from IPO Data, Warrington College of Business Administration, University of Florida (<http://site.warrington.ufl.edu/ritter/ipo-data/>). © The University of Melbourne.

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Slide 9: Prague castle, queue during an exhibition of Czech crown jewels (<https://flic.kr/p/eJs7fc>) CC BY-ND 2.0 (<https://creativecommons.org/licenses/by-nd/2.0/>).