

IPOs: The Short and Long of What We Know

FIELD NOTES

BY STEPHEN FOERSTER



One of the most important events in the life of a firm, and one of particular interest to institutional investors, is the transition from being a private company to a public one through the initial public offering (IPO) process. The IPO provides a fresh source of capital that is critical to the growth of the firm and provides the founder and other shareholders such as venture capitalists a liquid market for their shares. From an institutional investor's perspective, the IPO provides an opportunity to share in the rewards of the growth of the firm.

Given the importance of IPOs to pension funds and mutual funds, it is not surprising that much research has been devoted to the topic. We have made great strides in understanding the impact of IPOs, but many unanswered questions remain. I summarize what we know about IPOs, primarily from an investor's perspective, and I share some preliminary results of some research I am currently undertaking. I focus on research in the areas of short-run returns, hot and cold markets, long-run returns, global IPOs and withdrawn IPOs.

INITIAL RETURNS

If you are fortunate enough to get in on the ground floor of an IPO, short-run returns are often quite impressive. According to data compiled by Jay Ritter of University of Florida, over the last 40 years U.S. IPOs have enjoyed first-day returns of over 18%, while over the past 30 years Canadian IPOs have experienced initial returns of a more modest 6%. This phenomenon is also known as short-run underpricing, as the company appears to be "leaving money on the table."

There are a number of possible explanations for this short-run IPO phenomenon. One explanation is the rationing of a limited number of shares available in an

IPO. Since the number of shares subscribed often far exceeds the number of shares available, many investors face a potential "winner's curse" because they are only able to obtain a sufficient number of shares in less desirable IPOs. Thus these investors need to be enticed to buy new shares and the enticement takes the form of an initially low price. A second explanation is that underpricing can occur in order to create a "cascade" effect whereby initial investors are enticed to buy in, in the hope that more investors will follow. A third explanation is that firms wish to "leave a good taste" with investors since the firms may be planning to raise further capital in the future and hope to do so at more favourable prices. The bottom line for investors is: expect the best in the early days.

HOT AND COLD MARKETS

IPO markets alternate between hot and cold in terms of both initial returns as well as numbers of IPOs coming to the market. For example, according to data provided by Securities Data Corporation, after the October 1987 major market correction, the number of new U.S. IPOs in each year from 1988 to 1990 fell to about one-third of the 1987 level. The number of IPOs peaked in 1996, but the pace cooled dramatically during 2001 after the technology bubble burst. Average initial-day returns in 1987, 1988, and 1994 were below 10%, but climbed well over 50% in 1999 and 2000. More recent initial-day returns are much more in line with long-run averages. As experienced in 1999 and 2000, these hot markets are often concentrated in a small number of industries. For investors in hot markets, an IPO concentration can leave one vulnerable to any sudden sector downturns due to lack of diversification.

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LONG-RUN RETURNS

While the short-run performance of IPOs is often quite impressive, the long-run performance over the subsequent three to five years is not as impressive. Excluding the initial-day return, IPOs tend to underperform various benchmarks. According to Ritter, for U.S. IPOs that came to market between 1970 and 1998, the IPOs tended to underperform a sample of similar-sized firms by about 4% per year over the first three years (10.4% per year versus 14.2%), and by about 2% over the first five years (12.1% per year versus 14.0%). One always has to be careful in an IPO context interpreting these averages, since it is often the case that a small number of IPOs do spectacularly well while the majority are mediocre (in other words, these reported means are often much greater than the medians).

Researchers have suggested some possible explanations for these long-run IPO results. According to one explanation, the type of investors who buy in to IPOs tend to be the most optimistic. With an IPO, there is often great uncertainty about the long-term prospects of the firm. Over time, the uncertainty is resolved and the divergence of opinion between optimistic and pessimistic investors narrows, resulting in a relatively lower price. According to another explanation, investment dealers often act as impresarios, promoting and talking up IPOs in order to create the appearance of considerable demand for the stock. Thus many stocks that experience particularly large initial returns are often the same stocks that experience very poor long-run performance. According to a third explanation, the initial private owners attempt to take advantage of a window of opportunity when markets appear to be most receptive to IPOs and often issue at a time when market valuation metrics (e.g., price-earnings multiples) are above-average. Thus for investors, long-term performance is often disappointing.

GLOBAL CAPITAL RAISING

While many studies have focused on IPOs in a domes-

tic setting, Andrew Karolyi and I have investigated the growing phenomenon of non-U.S. firms raising capital in the attractive and receptive U.S. market. In a recent publication, "The Long-Run Performance of Global Equity Offerings," we investigated firms in 35 countries that issued equity (both IPOs and seasoned equity offerings) between 1982 and 1996, through the American Depositary Receipt (ADR) mechanism. We found that these global equity-offering firms underperformed various benchmarks by between 8% and 15% after three years, but there was considerable cross-section variability in our results. In particular, firms from countries with significant investment barriers for foreigners tended to outperform their benchmarks after controlling for other factors. In addition, non-U.S. firms that were able to capture a greater share of U.S. trading volume performed better. Thus, interpreting the performance of IPOs in a global setting is much more complex but there may be opportunities as well.

WITHDRAWN IPOs

In some currently unpublished work with my Ivey School of Business colleague, Craig Dunbar, we investigate the phenomenon of planned IPOs that are withdrawn from the market, an area of research that has not attracted considerable attention, but one that is growing in importance. Between 1987 and 2000, almost one-quarter of planned IPOs were withdrawn. In 2000, the level of withdrawn IPOs was over 40%. Many of these planned IPOs withdrew due to adverse market conditions, often with the expectation of returning during better times. However, our research shows that well below 10% of these firms make a subsequent successful return to the market. We further investigate the performance of these returning IPOs and find that while their initial one-day performance is slightly below that of relevant benchmarks, their performance over the subsequent year is much stronger. Thus these "second time lucky" IPOs may be worth watching, and may be worth the wait for patient investors. ♦