Discussion of:

Hot Markets, Investor Sentiment, and IPO Pricing

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Notes:

Great model.

- Like all good economic models, it captures what is probably an important aspect of the way a market works – here the IPO market.

- Like all good economic models, where exposition is important, to capture everything would be too complicated. So we need to understand the model's limitations.

- I want to do a couple of things in this discussion:

    1. Spell out how the model construction gets its results
    2. Spell out what the limitations of the model is in two (related) ways:
        (a) Where are the assumptions simplified, and how does this affect its implications
        (b) Talk about empirical data that isn't quite consistent with the (simple) model.

The Players

- There are five players:
  1. q_1 competitive early sentiment investors
  2. q_2 competitive late sentiment investors
     - The sentiment investors have limited credit.
  3. Competitive rational institutional investors
  4. Competitive potential underwriters
  5. A single firm with no positive NPV projects
- Players 1-4 all behave competitively.
- There is no information asymmetry.

Model Motivation

- Rents exist as a result of the sentiment investors. Since:

  1. the firm is a monopolist in its shares
  2. all other participants are competitive
  3. short sales are restricted

  the firm captures *all* of these rents.

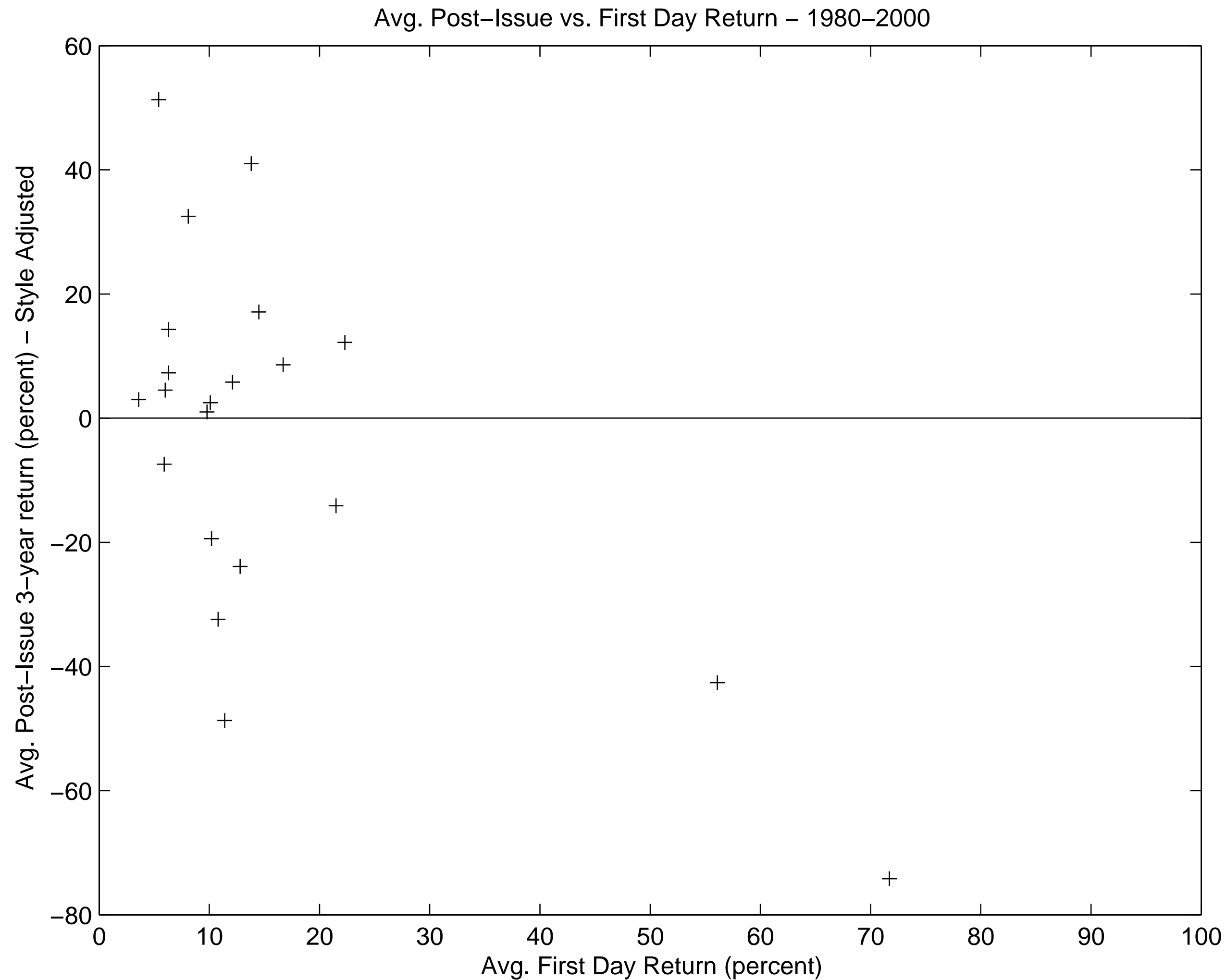
- The goal of the firm is to issue so as to maximize these rents.

- It does this by indirectly issuing shares at both time 1 & 2.
  - The institutional investors facilitate this delayed issuance, but don't get compensated for this.

Empirical Implications

- Underpricing/First-day return is negatively correlated with the post-issue return.
- Underpricing/First-day return is *equal to* expect future losses to the institutional investor.
- Flipping is aggressively punished.
- Filing-Price revisions are equal to the change in expected time 2 sentiment price-component.

First-Day and Post-Issue Returns



From Ritter and Welch (2000), Table 1

First-Day and Total Returns

Avg. Total Return vs. First Day Return – 1980–2000

Avg. Total 3–year return (percent) – Style Adjusted

Avg. First Day Return (percent)

Here, Total Return $\equiv (1 + r_{UP})(1 + r_{3y}) - 1$

Flipping

From Ritter and Welch (2002):

> *For IPOs with weak demand*, underwriters discourage flipping through moral suasion (i.e., the threat of withholding future allocations on hot issues) and the imposition of penalty bids.
>
> . . .
>
> *For IPOs where there is strong demand and a price jump*, penalty bids are rarely imposed, and flipping may even be encouraged in order to keep market demand from pushing the price to unsustainable levels.

Moreover Krigman et al. (1999) and Houge et al. (2001) find evidence that institutions identify and quickly flip IPOs that are more overpriced.

Sentiment and Institutional Investors

- Ben Dor (2003) examines post-issue IPO performance as a function of institutional ownership.
- He finds that the highest institutional ownership quintile outperform IPOs in the lowest quintile by roughly 12% in the year following the issue.
- Moreover, Ben Dor finds that the extra returns earned by the high IO stocks is later fully reversed.
  - However, institutions sell out before this decline.
- This suggests that institutions do a good job timing changes in sentiment.

Other Issues

- Underwriter/Firm Bargaining
- Underwriter/Institution/Firm Bargaining
- Sentiment Model?

Price Revisions

- Revisions (from original file price range) are highly correlated with first day return:
  - Avg. first day return for downward revisions is 4%
  - Avg. first day return for upward revisions is 32%.
  - Avg. monthly revisions are also autocorrelated out to 18 months.
- Revisions are positively related to past market returns up to 6 months prior to the IPO.