Initial Public Offerings: A historical overview

By Carsten Burhop, David Chambers, Financial Market History-Reflections on the past for investors today, The CFA Institute Research Foundation, 2016.

Introduction

An IPO is the first occasion when any security issued by the firm is traded on a stock exchange. An IPO is accompanied by the sale of securities, either existing or new.

Entrepreneurs face three key questions when it comes to IPOs :

- How soon can the firm go public?
- What price will the shares sell for?
- How will the shares perform after the IPO?

The IPO cycle

IPOs tend to cluster and go through cold and hot periods. During a hot period, many firms go public. During a cold period, few do so.

During a boom, capital spending increases and there may be more IPOs. During a recession, capital spending falls and there may be fewer IPOs. When investors are optimistic, there are more IPOs.

Hot markets may also be due to new industries with high levels of information asymmetry. In such industries, the first few firms going public are difficult to understand and value. But once these firms have gone public, it is much easier for other firms to float their IPOs.

Thus, IPO cycles and hot markets are quite common. Such markets can occur even globally. When compared to earlier IPO bubbles, the dotcom bubble of 2000 does not appear to be outsized.

Under-pricing

Under-pricing can be defined as the change from the IPO price to the closing price recorded on the first day of trading. The extent of under-pricing depends on many factors.

Younger and smaller firms are more risky. Since investors need to protect themselves, under-pricing is common.

A substantial portion of the under-pricing today represents rents extracted from issuers by underwriting investment banks and their closest investment management clients.

In economies where minority investors are well protected, under-pricing is less likely. The involvement of reputed banks and brokers who certify the quality of the IPOs can reduce under-pricing.

Long run performance

Cross country evidence on IPOs in the final decades of the 20th century typically reports underperformance relative to the overall market over the subsequent 3-5 years. But IPOs tend to feature small, growth firms. So their performance must be compared with seasoned firms that are also small growth firms, not the overall market. When benchmarked this way, IPOs do not seem to have underperformed.

Survival

The survival rate is defined as the proportion of IPOs that survive as public companies until their fifth anniversary. Failure is the delisting or liquidation of the firm in question. IPOs that disappear because of a merger are not considered failures.

Tighter regulation is positively correlated with higher survival rates. Statutory regulations work better than self-regulation. Only NYSE succeeded with self-regulation in the late 1920s. When it comes to studying the impact of regulation on IPO survival, we must appreciate that we can never know what firms would have gone public in the absence of regulation.

Conclusion

The tendency of IPOs to go through hot and cold markets is present throughout the 20th century.

IPO under-pricing may be a feature of the way in which capital markets have developed towards the end of the 20th century.

IPOs have underperformed vis a vis the overall market but at least in the US, they may not have underperformed when compared with similar firms.

IPO survival is less likely when regulation has been light or non-existent. The IPO survival rate increases when steps are taken to improve disclosures, listing requirements are tightened and steps are taken to protect investors.