What makes IPOs underpriced?

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ABSTRACT

This paper formulates a simple model to examine IPO underpricing by reviewing the financing strategies that start-ups companies are facing. In the analysis, an entrepreneur with a good technology and good management is unable to receive a satisfactory acquisition offer from a venture capitalist because of uncertainty about technological type and lack of diversification. For these reasons, if the entrepreneur also has a good managerial aptitude, he decides to go public and implement the project for himself. Otherwise, he would rather be acquired by venture capitalist.

This idea is modeled as a sequential signaling game, and initial results indicate that, in the primary securities market, underpricing serves as a necessary vehicle for quality signaling, and the level of this discount is positively related to the probabilities associated with good types of technology and management owned by the firm. Some preliminary empirical support for the model is also discussed.

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