Andreas Krause

Underpricing security issues

Reduced revenue from issuing securities

- A common observation is that the offer price of securities is below the first market prices
- This underpricing is especially prevalent in Initial Public Offerings
- Issuers are receiving less for their security than the market price before the fees are considered

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Benefits of underpricing

- It is often asserted that investment banks underprice securities to benefit investors they are allocating the security to
- Such benefits might be given as a reward for choosing the investment banks as advisor in other transactions
- We will see how issuers may be able to benefit from underpricing as it ensures the success of their security issue
- Investment banks may also directly benefit from underpricing by obtaining additional revenue from trading

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Winner's curse

- Uninformed investors will obtain a large allocation of the security if it is of low value as informed investors will not pay a high price
- A highly-valued security will be in demand by informed investors and uninformed investors will only obtain a low allocation of the security
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- If obtaining a large allocation, the uninformed investor will make a large loss and if obtaining a small allocation the security, the uninformed investor will make a small profit
- Overall, uninformed investors cannot make profits and would not demand securities
- We will see how underpricing addresses this problem and induces uninformed investors to demand securities

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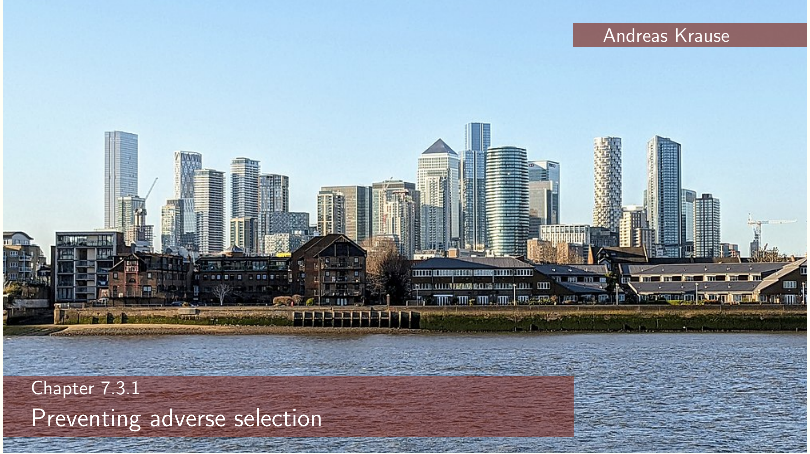

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Chapter 7.3.1

Preventing adverse selection

Discussion of the model results

- Underpricing is used to induce uninformed investors to demand securities as they will make a profit in successful issues
- This will allow securities with low demand to be issued successfully
- Why would a company issuing securities successfully, accept such underpricing?
- At the outset of the process, companies will not know whether their security issue will be a success; given that failing to sell securities might jeopardize future investment, accepting underpricing might be the best solution

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Trading due to underpricing

- Underpricing is associated with the discretion of investment banks to allocate securities to investors
- This may lead to a situation where investors valuing the security below the market price will be allocated them, they would want to sell their securities
- This may lead to a situation where investors valuing the security above the market price will not be allocated them, they would want to buy securities
- Investors will be trading the security and investment banks benefit through brokerage commission
- Lower offer prices also reduce the income from the underwriting spread to investment banks, requiring these two aspects to be balanced

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Chapter 7.3.4
Security flipping

Discussion of the model results

- Investment banks will optimally balance revenue from the underwriting spread and brokerage income from trading
- Underpricing only benefits investment banks at the expense of issuers
- ? Is the brokerage income the only benefit investment banks can generate from underpricing?
- ! They may also benefit their asset management if allocating them securities, reward clients for past or prospective business

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Summary of key results

- Underpricing is widespread and might benefit the issuer of securities by ensuring a successful offer
- Underpricing can also benefit the investment bank and be costly to the issuer
- Underpricing may also occur if the initial market price overvalues the security

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