

A wide-angle photograph of a city skyline viewed from across a body of water. In the foreground, there's a calm body of water with some ripples. Behind it, a row of older, multi-story brick buildings with dark roofs sits along the waterfront. In the background, a dense cluster of modern skyscrapers of various architectural styles, including glass facades and unique shapes, rises against a clear blue sky. A construction crane is visible on the right side of the skyline.

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Underpricing security issues

# Reduced revenue from issuing securities

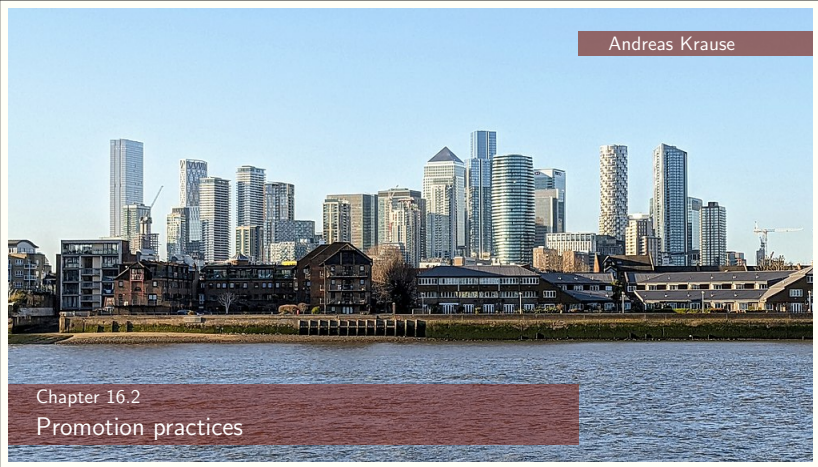
- ▶ A common observation is that the offer price of securities is below the first market prices
- ▶ This underpricing is especially prevalent in Initial Public Offerings
- ▶ Issuers are receiving less for their security than the market price, before any fees are considered

# 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

# 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
- ▶ A highly-valued security will be in demand by informed investors and uninformed investors will only obtain a low allocation of the security
- ▶ 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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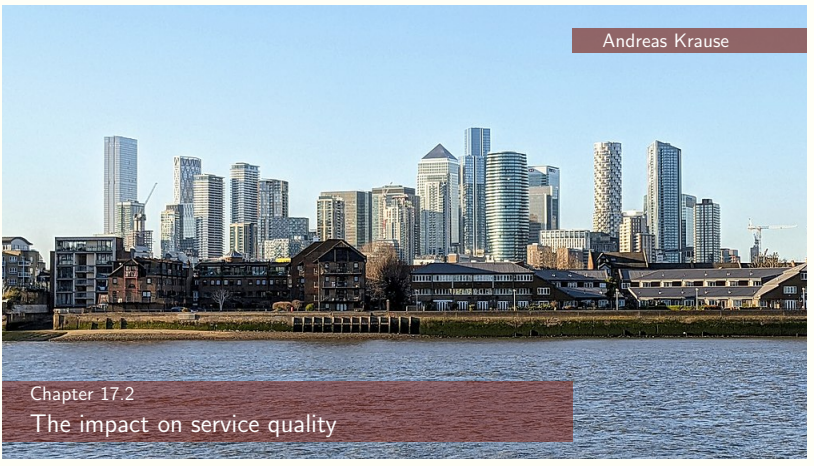
Chapter 7.3.1  
Preventing adverse selection

## 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

## 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

## 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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