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 any fees are considered

Benefits of underpricing

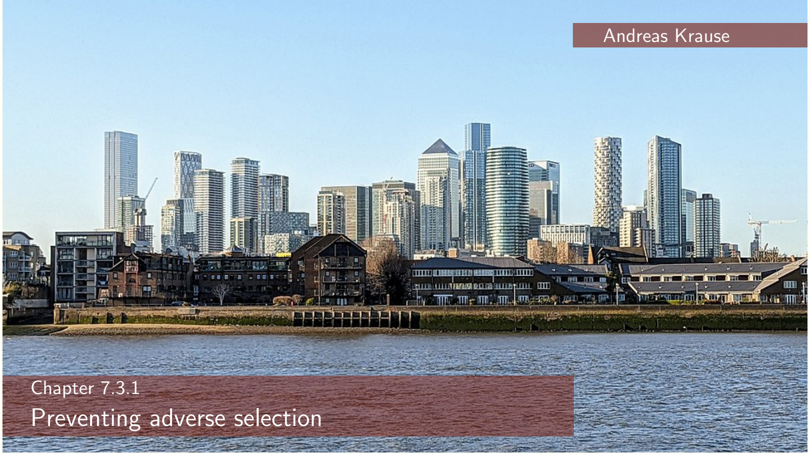
- It is often asserted that investment banks underprice securities to benefit investors they are allocating the security to
- Such benefits might be given as a reward for choosing the investment banks as advisor in other transactions
- We will see how issuers may be able to benefit from underpricing 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

$\Rightarrow$ 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



Andreas Krause

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

Andreas Krause

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

Andreas Krause
Department of Economics
University of Bath
Claverton Down
Bath BA2 7AY
United Kingdom

E-mail: mnsak@bath.ac.uk