First Day IPO Excess Return “Abnormality” in the US

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ABSTRACT

US IPO first day returns were approximately 17% on average between 2005 and 2021. The common explanation for this outperformance is due to the extra discount investors require to take on the risk of an uncertain event. This discount is significantly larger than capital raises through follow-on or later block offerings, but is not a result of mispricing. Rather, we believe issuers are incentivized to create a healthy IPO first day return in excess of the discount requested by the market for the long-term benefit of the companies. In our study we found that IPO issuers with positive first day returns outperformed those without in the one-year period post-listing, and had quadruple the market liquidity. Excess returns are also more apparent in companies offering smaller percentages of the stock, as the extra cost is more bearable in absolute terms.

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POSITIVE IPO FIRST DAY RETURN LEADS TO LONG TERM OUTPERFORMANCE

In our paper "Cost of Capital Raise", we found that first day IPO returns averaged 17.34% for IPOs from 2005 to 2021, while the discount required by subsequent offerings for over 30 days average daily volume (ADV) only averaged 7.59%—often with bigger sizing than IPOs. When stocks are actively traded in the market, offering discount average only 4.24% for offerings with less than 10 days ADV. The excess first day return for IPOs seems greater than what efficient market theory would suggest.

Investment banks would usually advise the management of a newly listed company to price itself at some discount to the average multiple of a comparable peer group. The discount compensates investors for taking on the risk of an uncertain event when a stock is first listed in the public market. However, if compensation for uncertainty is the sole purpose, the discount should not normalize on the first day of IPO. After all, a stock listed in the public market for one day is not very different from itself one day ago. It would take the company a few quarters to prove to the market that it can execute the business plan as envisioned. Hence, one should expect the newly listed stock to gradually close the valuation gap versus its peers over time rather than right on the first day of its listing. Therefore, we believe there are other reasons for management teams to price IPOs to allow for excess first day return.

By examining all operating company IPOs[1] between 2005 to 2020[2], we found that stocks with positive first day IPO returns outperform those with negative first day returns by about 8% over the first year, as shown in Exhibit 1 below. This gap is especially pronounced in technology IPOs where the outperformance tops almost 30% one year after IPO (see Exhibit 2). We believe that companies pricing themselves at lower than the fair market price is required for their own long-term benefit. Positive IPO returns generate positive press and investor sentiment. This virtuous cycle builds on the positive momentum to attract further institutional coverage and retail interest. The positive sentiment is especially important for technology IPOs, as they are mostly growth companies not yet generating profits at the time of their IPOs.

Exhibit 1: First Year Average IPO Return Over Time Excluding First Day Return

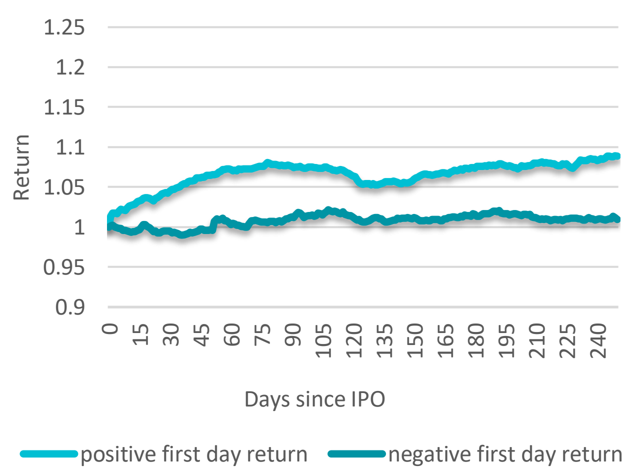
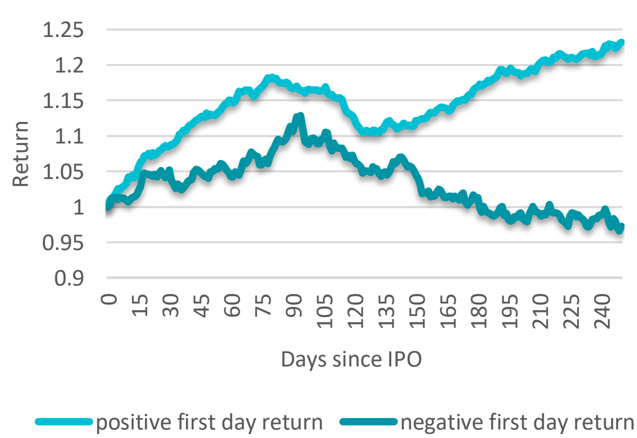


Exhibit 2: First Year Average IPO Return Over Time Excluding First Day Return for Information Technology Sector Only



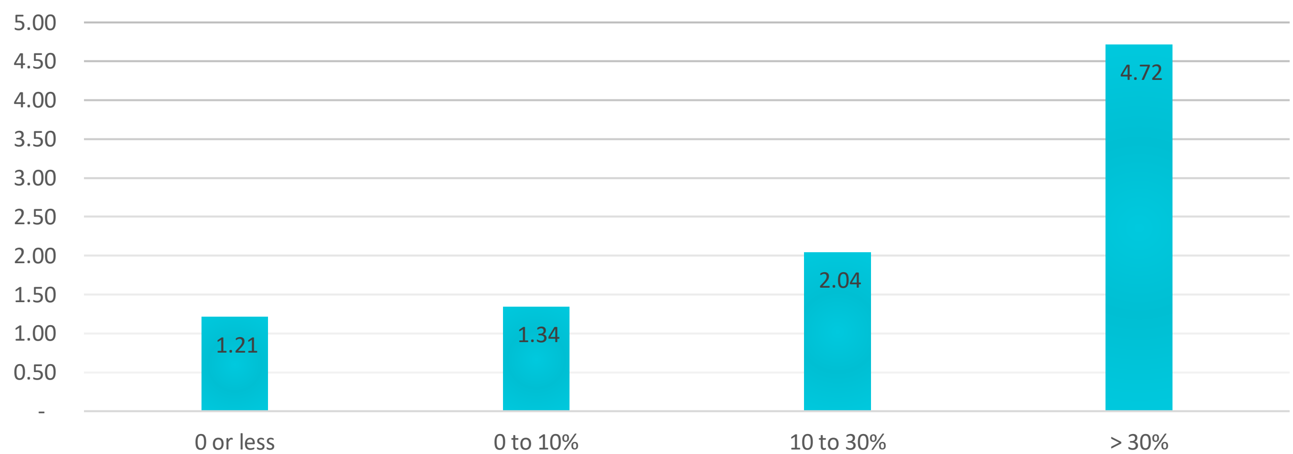
[1] We excluded all the SPAC IPOs because the dynamics of SPAC IPOs are significantly different from normal operating companies

[2] 2021 IPOs did not have full years of trading history at the time of writing and were hence excluded

POSITIVE IPO RETURNS BOOST TRADING VOLUME

In addition to the outperformance one year post IPO, positive first day return also boosted trading volume post IPO. The ADV is about four times more on average for IPOs with first day returns greater than 30% compared to those down on the first day (see Exhibit 3). The extra volume further evidences additional interest and coverage generated by the positive sentiment and return, and the extra liquidity also creates a virtuous cycle. As a result, companies can raise more capital at lower cost through follow-ons and blocks to support future growth or acquisitions.[3]

EXHIBIT 3: Normalized 1st Year ADV/Share Offered Grouped By IPO First Day Return



Source: CaaS Capital Management, Bloomberg, Capital Market Gateway.

SMALLER PERCENT OF COMPANY, MORE DISCOUNT

Companies offering smaller percentages are more willing to price cheaply to benefit from the positive momentum after the first day of IPO. These companies' returns are more positive on average on the first day and trend up for the first year (see Exhibit 4). The reasons for the excess discount for these companies can be:

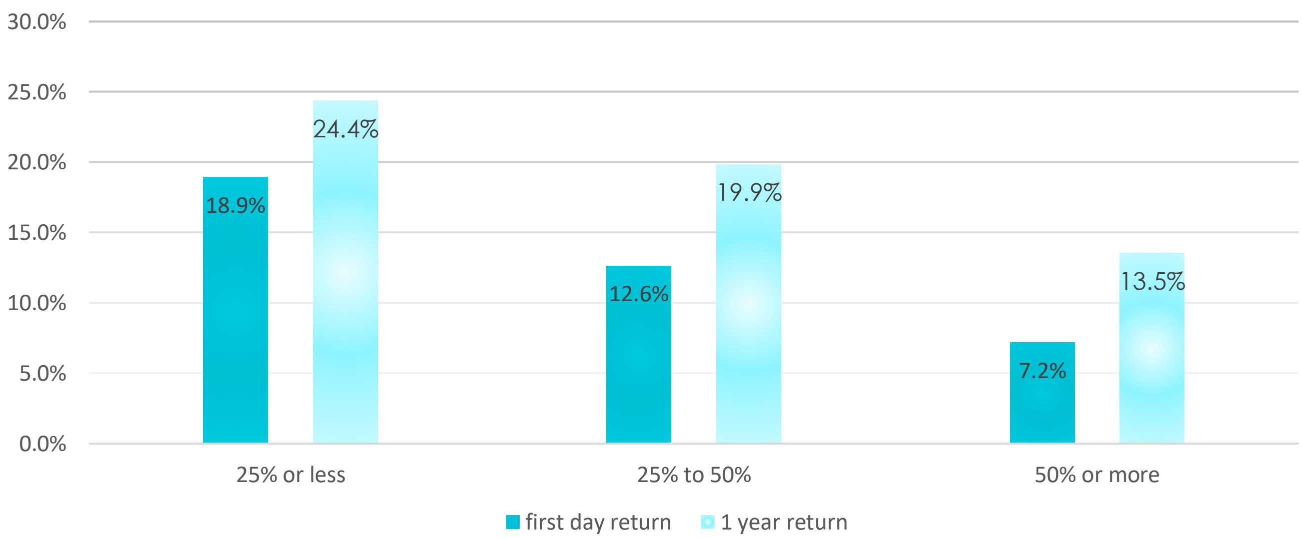
i) Smaller percent of the stock makes the steep discount easier to digest for the firm in absolute dollar terms;

ii) Management express confidence in the future value of their companies and are reluctant to sell too early.

[3] See impact of liquidity on cost of capital raise in "Cost of Capital Raise"

One might argue that a smaller offering creates a scarcity value for the company's stock price to be higher, but our data suggested otherwise. Companies that offered less than 25% of the total market capitalization continued to outperform those that offered more than 25% one year after the IPO, when most shares had unlocked for 6 months. The uptrend during the first year also has similar magnitudes across different initial offer sizes. If there is a scarcity effect, it would have disappeared as most of the stock are already available for trading in the market. Hence we believe the outperformance should be attributed to the extra discount during IPO pricing.

EXHIBIT 4: Average Return After First Day And First Year Post IPO Grouped By Percentage Of Company Offered At IPO



Source: CaaS Capital Management, Bloomberg, Capital Market Gateway.

CONCLUSION

We believe that newly listed companies are incentivized to offer shares at deeper discounts than an efficient market would require. This allows the stocks to build on the positive momentum to generate further return and liquidity over the first year as public companies. Growth companies are more incentivized to offer deeper discounts as positive sentiment is more important for future valuation. The extra discounts offered by companies during the IPO create a mutually beneficial structure for both the companies and investors. Companies will enjoy higher valuation over time and IPO investors generate positive returns initially and are incentivized to stay for the long term. As management teams understand their IPOs will be priced below market value, they usually choose to offer small percentages of their companies, so the absolute cost in dollar terms is minimized.

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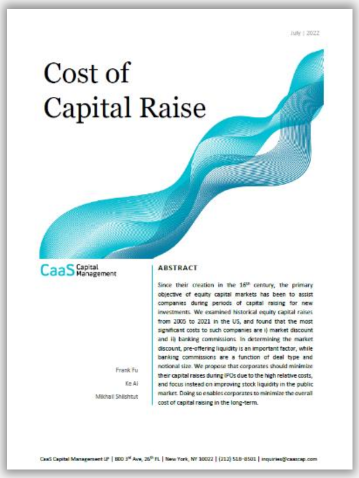

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Cost of Capital Raise

CaaS Capital Management

ABSTRACT

Since their creation in the 16th century, the primary objective of equity capital markets has been to assist companies during periods of capital raising for new investments. We examined historical equity capital raises from 2005 to 2021 in the US, and found that the most significant costs to such companies are i) market discount and ii) banking commissions. In determining the market discount, pre-offering liquidity is an important factor, while banking commissions are a function of deal type and notional size. We propose that corporates should minimize their capital raises during IPOs due to the high relative costs, and focus instead on improving stock liquidity in the public market. Doing so enables corporates to minimize the overall cost of capital raising in the long-term.

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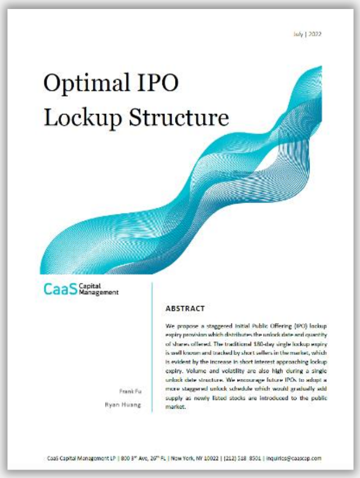

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Optimal IPO Lockup Structure

CaaS Capital Management

ABSTRACT

We propose a staggered Initial Public Offering (IPO) lockup expiry provision which distributes the unlock date and quantity of shares offered. The traditional 180-day single lockup expiry is well known and tracked by short sellers in the market, which is evident by the increase in short interest approaching lockup expiry. Volume and volatility are also high during a single unlock date structure. We encourage future IPOs to adopt a more staggered unlock schedule which would gradually add supply as newly listed stocks are introduced to the public market.

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