Trending in What Direction? The Impact of IPO Hype

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There were 1,035 U.S. companies that went IPO in 2021 with a median deal size of $180 million, translating to over $186 billion in capital gained by firms and their owners. These numbers are huge especially when you consider that just a few years ago it looked like IPOs were falling out of fashion, entrepreneurs were considering other exit strategies, oh, and there was a global pandemic.

So, what should you know if you're looking to take your company public or if you're looking to invest in an IPO firm? First and foremost, the IPO process is an information game. As an owner, your goal is to convey to institutional investors the information that will lead to the most favourable offer price – maximizing your investment. At the other end of the table, institutional investors are looking for information that helps them predict how the market will react to the company stock. This information includes the good and the bad.

Traditionally, the way that information is transmitted from the firm during an IPO is via earnings documents, SEC filings, and the roadshow. In turn, the underwriter – working on behalf of the company – will communicate with institutional investors and relay their interest back to the company owners, helping to establish an offer price. The final offer price tends to be reasonably close to the initial offer price spread (or range) that companies report at the beginning of the IPO process, but it can change based on new information gained by institutional investors that causes them to either be more bullish or bearish in their opinion of how the firm's stock will perform.

Research has shown that substantial changes in the final offer price from the original price range sends strong signals to the market. These signals can either be positive – an increase in the offer price can indicate that investors have acquired new information that points to better performance – or negative – investors might be sceptical about new information or lack important information. However, market reactions to these signals can be volatile so most underwriters will work to reduce the amount and size of pricing changes during the IPO process.

Historically, researchers have pointed to information asymmetry as the major culprit in large pricing changes during IPOs. This makes sense as a lack of information or ambiguous information results in uncertainty – a.k.a. risk. Savvy institutional investors are pretty risk averse, so they will only be willing to take on a small portion of the risk resulting from information asymmetry, potentially lowering the price they are willing to pay.

However, recent changes in SEC regulations on IPOs would seem to remove a lot of the sources of information asymmetry. In 2019, the SEC opened up their "testing the waters" amendment to all firms looking to go public. This ruling removed most of the regulations that barred firms from interacting with institutional investors prior to officially filing intentions to IPO. The new provisions mean that companies can candidly share information with institutional investors, reducing the information gap between both parties without the ticking clock of the official IPO process.

While the 2019 SEC ruling did achieve success in allowing entrepreneurs to feel more confident about their chances of successfully going public (a quick glance at the annual number of IPOs shows this clearly), there is still uncertainty in the process. Offer prices are still being adjusted, indicating that institutional investors aren't fully confident in their evaluations. While some of the old causes of uncertainty are certainly partially to blame (companies will still choose to withhold or spin some information regardless of time horizons), recent research points to another factor – hype.

Hype occurs when the public reacts strongly to signals about a firm going public. The more people tweet, post, and blog about a company, the more their sentiments and opinions align and grow through a process known as social contagion. Emerging research is finding links between public sentiment and institutional investor decision-making. Institutional investors weight their opinions, and in turn their check books, based on the sentiment of the market, not just on earnings reports.

Our research has shown that higher public sentiment and demand surrounding a firm leads to higher first-day returns. Indeed, as public hype increases for a firm, their first-day returns can outperform their peers by as much as 64 percent when the final offer price is adjusted above the initial price range. However, when institutional investors price the IPO below the initial offer price range first-day returns stagnate at under three percent.

What does this mean for entrepreneurs looking to go public?

1. Be aware of the public perception of your company as it plays a large role in how institutional investors will price your IPO.
2. Account for public hype when determining an initial price range. While you want to maximize your investment by pricing the shares high, if hype is low or negative this can lead to negative offer price changes that will damage your shares' value post-lockup.
3. Leverage positive hype during the roadshow. Investors should know that public sentiment is high and reward you.
4. Manage your information dissemination as much as possible. It can be tempting to push out as much positive information as quickly as possible when going public. However, if hype is already high, more information could get lost as noise.

The internet is the new office water cooler and what people are saying about your company can make or break your success at the ring of the bell.

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