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IPOs and Entrepreneurial Firms

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Contents

1 Introduction **2**

2 The Going Public Decision **5**

3 Pricing and Valuation **22**

4 Intermediaries in the IPO Process **32**

5 Short- and Long-Run Performance **40**

5.1 Underpricing 42

5.2 Long-Run Underperformance 45

6 Trends in the Number of IPOs **64**

7 Directions and Trends **68**

References **71**

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IPOs and Entrepreneurial Firms

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ABSTRACT

The listing on a stock exchange is a paramount milestone in the life cycle of an enterprise. By taking their company public on a stock market through an Initial Public Offering (IPO), entrepreneurs may target several benefits (e.g., raising money, facilitating acquisitions, offering valuable stock ownership plans to employees) but their firms will bear new costs and requirements. In this work we review the academic literature on IPOs of entrepreneurial firms, focusing on five main topics: (i) the going public decision, (ii) pricing and valuation, (iii) the role of intermediaries and underwriters in the listing process, (iv) the performance of IPO-firms in the short and long run, and (v) market cycles in the IPO industry.

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1

Introduction

An initial public offering (IPO) allows a privately held company to raise capital by offering equity stock to the general public. Companies involved in IPOs are aware of the potential benefits. The money raised may increase its growth capital. The entrepreneurs obtain an objective valuation of their company. On the other side, the status of a listed company increases public exposure and is associated with increased costs and requirements.

The first IPO in the United States was in 1783 when Bank of America went public by selling shares of stock. In Europe, the Dutch East India Company issued public shares in 1602 to raise capital to fund the expansion of its operations. Notwithstanding more than 400 years passed away, taking a company public holds a special place in entrepreneurs' (and investors') imagination. IPOs are glorious and well-publicized. They certify that a company did not fail and may continue to grow autonomously, with thousands of shareholders trading the stock and new wealth created.

In this monograph, we propose an analysis of the most recent literature on IPOs of entrepreneurial firms, focusing on the contributions published mainly in entrepreneurship and finance journals. We refer to

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entrepreneurial firms as young firms, based on intangible rather than physical assets, where the founder of the firm often serves as the key inventor and the CEO. Although taking an entrepreneurial perspective, a contribution of this monograph is to bring together different streams of literature. Entrepreneurial finance literature is indeed largely segmented (Cumming and Vismara, 2017). Different streams of the academic literature between entrepreneurship and finance have become segmented for reasons of theoretical tractability and data availability. The literature on entrepreneurial finance has evolved through distinct paths, with the same topic often being addressed from multiple perspectives. When different streams of research study the same thing, authors might respond by conveniently ignoring work by other authors, to make their studies look innovative to a segmented readership. In this monograph, we aim at contributing to reducing this gap by highlighting topics that have been widely investigated by scholars as well as pointing out themes that are still relatively uncovered.

The subject of the monograph, IPOs and entrepreneurial firms, covers a very broad area of topics. The richness of the literature spanning from finance to management journals forces us to make some choices. While many aspects of the IPO process are of interest and many theoretical advancements have been put forward, this study is necessarily focused on a few ones. For sake of focus, we did not consider relevant aspects such as the role of financial intermediaries or the role of the policies and regulation. We do consider IPO performance but only in terms of short-term or long-term share price and operating performance, paying little attention to other measures such as the survival of IPO firms. A broader range of topics are discussed in previous works on IPOs, such as Levis and Vismara (2013) or Lowry *et al.* (2017).

Both IPOs and entrepreneurial ventures vary across "space and time". This survey is less focused on the context but more on general findings which, we acknowledge, could not necessarily be generalized or treated as stylized facts. A clear example comes from the valuation of firms going public. To satisfy investors' demand for reliable valuation guidelines, scholars have highlighted several interesting "stylized facts," mainly related to the valuation of IPOs. For instance, existing studies find that the skills and abilities of entrepreneurial teams, along with

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affiliation with prestigious third parties, are effective signals of firm quality, leading to higher valuation (e.g., Bruton *et al.*, 2009; Sanders and Boivie, 2004). However, the fragmented nature of this evidence prevents it from providing reliable theory-based guidelines for investors, either professional or retail. In particular, whether this evidence can be extended to other financial milestones, such as private deals or equity crowdfunding offerings (Block *et al.*, 2018), is debatable.

The structure of this work is as follows. In Section 2 we review the literature on the reasons why companies go public. A trade-off between direct and indirect costs and benefits is considered, as well as entrepreneurial strategic objectives, comprising engaging more easily in acquisitions, signaling the quality of the company, increasing its reputation. Section 3 deals with alternative methodologies to price IPO shares, including cash flow discounting and peer comparison. Section 4 describes the role of intermediaries in the placement of IPO shares. Section 5 focuses on the short-run (underpricing) and long-run performance of IPO companies. Section 6 discusses the cyclical dynamics of the IPO flow on the market. Finally, in Section 7 we identify future research directions at the cross-road between finance and entrepreneurship and comparing IPOs with new digital finance, with the hope to help de-segmenting research and provide new ideas.

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