How may VC-backing affect the IPO characteristics of a firm when it goes public through the investor attention channel? To address this question, we start by assuming that for institutional investors to participate in a firm's IPO, they not only need to receive information about various aspects of that firm from an investment bank, but also to pay attention to or "recognize" this information. This last assumption is in the spirit of Merton (1987) investor recognition model, the above assumption means that the cost of paying attention to VC-backed IPO firms will, on average, be lower compared with that for paying attention to non-VC-backed IPO firms. This, in turn, implies that institutions are more likely to pay attention to a particular IPO if that IPO is VC-backed.

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We then argue in our paper that an important effect of VC-backing is to induce a larger number of institutions to pay attention to an IPO firm, thus making it easier for the lead underwriter to disseminate information about the firm to institutions and to extract information from them about their demand for the IPO firm’s equity. This has implications for various IPO characteristics such as the absolute value of IPO offer price revision; IPO and immediate secondary market valuations of the firm; IPO initial returns; and participation by institutional investors and financial analysts in the IPO or its immediate secondary market (the former by holding IPO firms’ equity and the latter by providing analyst coverage). We test these implications in our empirical analysis.

The results of our analysis of the relation between VC-backing and investor attention can be summarized as follows. First, we find that VC-backed IPOs are associated with a greater amount of investor attention as proxied by pre-IPO media coverage (the number of headlines and articles covering the IPO firm in the two months prior to the IPO date). Second, high-reputation VC-backed IPOs receive greater investor attention than low-reputation VC-backed IPOs. Third, the results of our instrumental variable analysis using the returns earned by limited partners of a venture capital firm as an instrument for VC backing confirms that the relation between VC backing and greater investor attention is causal.

We then discuss the results of our analysis of the relation between VC-backing, investor attention, and IPO characteristics. First, VC-backed IPOs are associated with larger absolute values of IPO offer price revisions. Further, our interaction tests reveal that, even after controlling for the direct effect of VC-backing, there is an incremental positive effect of higher (above median) investor attention received by VC-backed firms on the absolute value of IPO offer price revisions. Second, VC-backed IPOs are associated with greater IPO and secondary market valuations, and greater IPO initial returns. Further, our interaction tests reveal that, even after controlling for the direct effect of VC-backing, there is an incremental positive effect of higher (above median) investor attention received by VC-backed firms on IPO- and secondary market valuations as well as IPO initial returns.

The above results suggest two things. First, VC-backed firms have more favorable IPO characteristics, namely IPO and secondary market valuations and IPO initial returns, than non-VC-backed firms. Second, the productivity of investor attention (in generating IPO and secondary market valuations and IPO initial returns) is greater for VC-backed than for non-VC-backed firm IPOs. This suggests that, even if part of the higher valuations (and higher IPO initial returns) of VC-backed over non-VC-backed IPO firms is due to differences in intrinsic firm quality, investor attention plays a significant role in generating higher values of these variables in VC-backed over non-VC-backed firm IPOs.

The results of our analysis of the relation between VC-backing and participation by important financial market players in a firm’s IPOs are also broadly supportive of the investor attention channel. First, VC-backed IPOs have a greater number of institutional investors holding the firms’ equity and have greater analyst coverage post-IPO. Further, our interaction tests reveal that, even after controlling for the direct effect of VC-backing, there is an incremental positive effect of higher (above median) investor attention received by VC-backed firms on institutional investor participation and analyst coverage.

The results of our analysis of the dynamics of IPO firm valuation over time are also supportive of the investor attention channel. We find that the secondary market valuation of VC-backed IPO firms fall to a greater extent from the first trading day post-IPO through the three years following the IPO date. Further, our interaction tests reveal that, even after controlling for the direct effect of VC-backing, VC-backed firms that received higher investor attention have a greater fall in valuation as time passes after IPO. These two results, taken together, suggest that the higher market valuation of VC-backed firms that we document at IPO is at least partially due to the greater investor attention received at IPO by such firms, as evidenced by their valuation falling to a greater extent as investor attention dissipates with the passage of time after IPO.

This post comes to us from Professor Thomas Chemmanur at Boston College’s Carroll School of Management, Professor Karthik Krishnan at Northeastern University and Qianqian Yu, a Ph.D. candidate at Boston College. It is based on their recent paper, “Venture Capital Backing, Investor Attention, and Initial Public Offerings,” available here.