Socioemotional Wealth and IPO Underpricing of Family Firms

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Socioemotional wealth (SEW) is the noneconomic utility that a family derives from its firm ownership. These include family reputation and influence. Extant literature suggests that family firms are willing to sacrifice financial gains to preserve SEW. In this study, the authors examined the initial public offers (IPOs) of shares made by 153 German companies. They argued that family firms underpriced their IPOs and sacrificed proceeds to preserve their SEW or noneconomic utility.

SEW Loss Aversion

Strategic decision-making at family firms is often influenced by their tendency of loss aversion with regard to noneconomic utility or SEW. For instance, family firms are ready to accept lower profitability and long-term performance in order to preserve SEW. They also limit diversification or expansion if they do not find trusted family members to supervise those businesses. Family businesses often avoid downsizing, pursue fewer socially/ environmentally harmful business activities and engage in more philanthropic activities, compared to non-family firms.

An IPO potentially damages SEW as nonfamily shareholders increase their influence in the firm. It also hinders the family's pursuit of noneconomic goals and its authority. However, the firm still opts to launch an IPO when the economic utility of additional capital brought in through the IPO exceeds the noneconomic utility of continuing as a private firm. The authors suggest that when a family firm launches an IPO, it tries to minimize the SEW losses even if it requires sacrificing gains from selling shares. The authors explain this phenomenon based on the Behavioral Agency Model (BAM). They suggest that it occurs because for the owner family ***avoiding socioemotional losses is more important than obtaining financial gains***.

What is IPO Underpricing Phenomenon?

IPO underpricing is indicated by the increase in ***closing price on the first day*** of stock trading ***compared to the issue price***. In other words, it is the discount the firm offers in its IPO to the fair value of its shares. Though professional advisors for the IPO (like, investment bankers) help the firm assess the fair value of its shares, the family management willingly chooses to offer a price below that. This phenomenon has been repeatedly observed in IPOs launched by family firms.

SEW Preservation at the time of the IPO

The authors suggest that the issuers willingly underprice shares to generate oversubscription for the IPO. This ***results in rationing of shares***, which ***reduces ownership concentration*** among new shareholders. Reduction in concentration of non-family share ownership helps the family in ***retaining influence over the firm*** and thus preserves SEW.

In addition, underpricing of shares reduces the risk of a failed or withdrawn IPO. A ***failed IPO*** does not only have monetary costs (i.e., marketing costs, fees to consultants, bankers and advisors etc.) but also ***costs in terms of reputation***, a SEW factor that family management want to preserve.

Family firms also wish to prevent IPO related lawsuits to preserve their reputation. Therefore family firms willingly adopt IPO underpricing to preserve SEW.

The authors found strong support for their hypothesis in the data analysis. On an average, ***family firms*** were found to have ***underpriced their IPO by 10 percentage points compared to the nonfamily firms.***

Practical Implications

The key implication of this research for family firms is that the firms that plan for IPOs must be aware of the possibility of underpricing the issue that might help them preserve SEW. The family managements need to determine the level of economic gains they are willing to sacrifice for preserving SEW. It is critical for them to arrive at this through a consensus.

In order to minimize the costs of preservation of SEW, family firms can decide to offer smaller number of shares in the IPO and sell additional after the IPO. Family firms must also become aware of the underpricing pitfalls so that the aggressive investment bankers that desire higher underpricing do not take undue advantage. Thus, while pricing the IPO they need to strike the right balance between the economic sacrifice they are willing to undertake and their objectives of SEW preservation.

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