

Measuring Market Power in the IPO Underwriting Industry

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Abstract

The existence of collusion in the IPO underwriting market has received increased attention. Economists are divided on the issue whether the spread of the IPO service is determined by collusive pricing behavior. This article contributes to this important debate by empirically understand the nature of underwriter competition in the Japanese IPO underwriter market.

The first step is the estimation of demand function. The demand function depends on the spreads offered by the underwriters, underwriter reputation (underwriter asset size, average underpricing) and issuer's characteristics (average issuer asset size, average issuer asset leverage and average secondary share portion). Issuer's demand is identified from aggregate market shares. We model that issuers choose a type of underwriters first, and then choose an underwriter. We find that issuers face downward-sloping demand curves.

The second step, we test underwriter conduct. Once the demand function is estimated, it can be used in turn to back out the marginal cost implied by three industry structures: Bertrand competition, partial collusion and joint profit maximization. We then use the Rivers and Vuong (2002) test for selecting the model that best fits the data among these models. The results suggest that the marginal cost implied by the joint profit maximization models best fits the data. This implies that pricing in the IPO underwriting markets is collusive. We also found that Bertrand competition fitted the data better in 2002 when the participation effect of bank competition was stronger, but this effect disappeared afterwards. This is consistent with Hatfield et al. (2020) that market entry may facilitate collusion in syndicated markets.