

# **Derailed by the Election: IPO Activity Under Election Uncertainty\***

**Gonul Colak**

College of Business, Florida State University, Tallahassee, FL 32306-1110

**Art Durnev**

Henry B. Tippie College of Business, University of Iowa, Iowa City, IA 52241-1994

**Yiming Qian**

Henry B. Tippie College of Business, University of Iowa, Iowa City, IA 52241-1994

January 11, 2013

## **Abstract**

We analyze the IPO activity under the political uncertainty surrounding the gubernatorial elections. The year of the gubernatorial election sees substantially fewer IPOs originating from that state. This reduction in IPO activity is related both to the delayed action by the firms due to increasing cost of capital under political uncertainty, and to the diminishing investors' demand for risky IPO shares due to elevated valuation uncertainty. These findings confirm that policy uncertainty delays major commitments by the firms, such as initial public offerings. Finally, our findings suggest that the state-level elections carry substantial political uncertainty that affects corporate decision making.

*JEL classification:* G32, G38, H70, R50

*Key words:* gubernatorial elections; initial public offerings; policy uncertainty; underpricing.

\* Preliminary and incomplete.

## 1. Introduction

Political uncertainty is an important factor that affects firms' decisions. Firms reduce their investment in the face of political uncertainty (Rodrik, 1991; Pindyck and Solimano, 1993), or in the face of macroeconomic uncertainty which can be affected by the political uncertainty (Cukierman, 1980; Bernanke, 1983). Studies such as Barro (1991), Alesina and Perotti (1996), Leahy and Whited (1996), Chen and Funke (2003), and Julio and Yook (2012) provide empirical results consistent with these theoretical arguments. Durnev (2012) finds that corporate investment decisions are less sensitive to stock prices during national election years. Bloom et al. (2007) and Bloom (2009) argue that investment is lower and less responsive to changes in demand conditions when policy uncertainty is large. In short, because large investments are usually irreversible and carry major fixed costs, the decision to invest is very sensitive to the macroeconomic and political environment. When firms face uncertainty, they prefer to delay such irreversible actions.

The above papers, however, focus mostly on the aggregate macroeconomic uncertainty and the nationwide political uncertainty, and their impact on capital spending by the firms. In this paper, we extend the above chain of evidence to other major irreversible decisions by firms. Namely, we analyze how the Initial Public Offering (IPO) activity is affected by the gubernatorial elections of the state the firm is located in. Like the investments decision, the IPO decision involves major risks of failure and major costs in case of failure.<sup>1</sup> Another similarity between the investments decision and the IPO decision lies in its sensitivity to the macroeconomic conditions (see Lowry, 2003; Pastor and Veronesi, 2005; and Ivanov and Lewis, 2008). Therefore, the IPO market is also likely to be affected by the political uncertainty. For the first time in the literature we aim to show this effect.

We primarily focus on the U.S. gubernatorial elections, since the state government exerts significant influence over a state's economy by shaping and implementing economic policies which are subject to uncertainty. Political uncertainty arises from gubernatorial elections, because a state's economic environment can dramatically change depending on elected

---

<sup>1</sup> The IPO decision is irreversible, because it involves various fixed costs associated with a "failed IPO." Dunbar (1998) shows these costs are substantial and involve issues such as negative publicity, loss of managerial labor, various fees, etc.

governor's policy preference (see Besley and Case, 1995; and Peltzman, 1987, among others). A recent paper by Jens (2012) confirms that the policy uncertainty due to gubernatorial elections do matter to the firms' investment activity.

Therefore, for a small private firm located in a state facing a gubernatorial election, the political uncertainty surrounding this election can be of utmost importance. Very likely, the entire business operation of this firm is located in that state, and the regulations and policies imposed on the state will affect this firm's operations substantially. There will be major uncertainties about this firm's future cash flows due to the possible policy changes brought by electing a particular governor. If the cash flows are affected, the valuation of the firm will be affected, which brings a major uncertainty to the IPO process of this firm. If the firm conducts an IPO with such a cloud of uncertainty surrounding its future business, it is likely that the IPO may not be as successful. Hence, waiting for a resolution of this uncertainty seems optimal for this firm, and it will decide to wait until after the election.

Consistent with this notion, we find that the IPO activity during the election year is suppressed in that state, and in the year after the election IPO activity jumps substantially. Moreover, as depicted in Figure 1, the IPO activity follows a pattern consistent with the 4-year election cycle of the states. The year that typically involves the highest policy uncertainty (i.e., the election year) sees the fewest IPO events, and the year that is the farthest away from an election (i.e., the year that is two years separated from any election) sees the highest number of IPO events.

Multivariate regressions confirm this decline. Controlling for state's GDP growth rate, nationwide business cycles, the prevailing long-term interest rates (cost of debt), the stock market effects, and the state-wide or nationwide hot IPO markets, the IPO activity in an election year is still lower than the off-election years. The post-election jump in the IPO activity is robust to these controls, as well.

To assure that other invisible effects do not cause complications in our estimation of political uncertainty's impact on IPO activity (some such effects might be, regional effects, endogeneity issues, and so on), we devise and implement a new methodology. We term it *the neighboring state methodology*, and its purpose is to address endogeneity due to two sources: i) there are

other (than election) state economic factors that affect electoral uncertainty and electoral outcome; ii) electoral uncertainty and outcomes are themselves depend on state economic factors we cannot account for. The implementation of the methodology is based on synthetic control method based on time consuming simulations that involve all the neighboring states of the state that a particular IPO is located in. The results from this estimation procedure suggest that it is unlikely that the slowdown in the IPO activity before the gubernatorial elections is driven by any other reason than the election uncertainty.

Further analysis into the political uncertainty reveals that its effects are even more pronounced in the gubernatorial elections that are associated with the highest policy uncertainty. We classify the elections into high-uncertainty and low-uncertainty election using three different criteria. As our first criterion, we sort the elections into terciles according to how close was the vote, and classify the ones with the narrowest (widest) voting margins between the winning and the second-best candidates into the high-uncertainty (low-uncertainty) elections. In our second criterion, we consider an election as high-uncertainty one, if the election resulted in a change in the governor and it was close (winning margin is less than 5%<sup>2</sup>). All the other elections are considered low-uncertainty elections. As our third sorting criterion, we check whether there is an incumbent running in the election, and if not, what is the reason for the incumbent not running (term limitation, early retirement, lost in the primaries, etc.). The incumbent governors tend to win their re-election bids roughly two-thirds of the times (Cover, 1977). So, regular elections (i.e., excluding the special elections) that do not involve an incumbent, and the reason for this non-involvement is not term limit, are considered high-uncertainty elections. The remaining elections are considered low-uncertainty elections. Our multivariate regressions results indicate that the high-uncertainty elections cause substantial slowdowns in the IPO activity, regardless of which of the above three criteria we use.

After establishing that gubernatorial elections lead to fewer IPO events, we determine the channels of impact through which election-related uncertainty could affect the private firms' decision to delay their issuance. First, some private firms may react to elevated asymmetric

---

<sup>2</sup> The average winning margin for our 317 gubernatorial elections is about 16.5%.

information environment in a risk-averse fashion. Pastor and Veronesi (2012a) show theoretically that economic policy uncertainty lowers stock valuations. In an empirical study Brogaard and Detzel (2012) find that the economic policy uncertainty depresses asset values through a mechanism involving firms' cash flows and discount rates. Therefore, some firms believing that their equity will not be fully priced, and their costs of equity financing could be high, would delay major and costly equity issuance, such as conducting an IPO. Thus, the first channel through which political elections affect the IPO activity is by raising the costs of new public equity (i.e., increasing the financing constraints) for the firms, and thus reducing the firms' incentives to supply new equity. We term this channel of impact as *the higher cost of equity explanation* (or *increasing financing-constraints explanation*).

The second channel of impact could occur through the investors' demand for new equity shares. As mentioned above, Brogaard and Dietzel show that higher economic policy environments create uncertainty about firms' cash flows. Such a valuation uncertainty about the new and risky equity shares would discourage many risk-averse investors to participate in such offerings. Hence, the political uncertainty would likely change the investors' attitude and enthusiasm toward the IPO shares, which will affect the observed underpricing (Derrien, 2005; Ljunqvist, et al., 2006). The private firms will discover this change in investors' demand through the signals generated by the outcome (and/or underpricing) of the prior IPOs, and some of them will delay their issuance (see, among others, Lowry and Schwert (2002), Pastor and Veronesi (2005), and Colak and Gunay (2011), for some examples on how prior IPOs or prior level of underpricing generate signals about the IPO market's conditions). This channel of impact indirectly affects the IPO activity, and can be termed *the diminishing demand for equity explanation*.

To look for evidence of such channels, we design an empirical estimation that uses underpricing as a stepping stone. First, we determine whether the election-year IPOs<sup>3</sup> are more or less underpriced than off-election IPOs. Using an estimation set-up similar to Loughran and Ritter (2004)'s underpricing regressions, we determine that election IPOs have significantly lower underpricing. This result is not affected by the fact that the decision to conduct an IPO

---

<sup>3</sup> An *election-year IPO* or simply an *election IPO* is an IPO that was issued within twelve months prior to a gubernatorial election of its state. An *off-election IPO* is an IPO conducted in any other time than the election year.

during the election year and the IPOs underpricing may be simultaneously determined by the same internal and external factors.

Lower underpricing during election years can occur due to many reasons.<sup>4</sup> To better assess the reasons for the lower underpricing, we analyze its two components: the IPO's offer price and the first-day closing price of its stock. *Ceteris paribus*, if the lower first-day closing price is the reason for the lower underpricing, then it is likely that demand for the IPO shares is suffering due to election uncertainty. Alternatively, the firms' might have set the offer price too high, and the underpricing reflects that.

Using the same estimation set-up used for underpricing regressions,<sup>5</sup> we determine whether the suppliers of equity (through the offer price) or the investors' demand for equity (through the first-day price) determine the equilibrium underpricing. Our estimations show that, *ceteris paribus*, the offer price of election IPOs is set lower (not higher) than the off-election IPOs. We also find that mean price revision of election IPOs is to the downside (i.e., it is negative), and for the off-election IPOs it is to the upside (positive). Furthermore, the proceeds raised by the election IPOs per dollar of assets are significantly lower. All of this evidence suggests that the election IPOs are facing more stringent equity-financing constraints (i.e., higher costs of equity) than the off-election IPOs. We interpret these results as supportive of *the increasing financing-constraints explanation* for the anemic IPO activity under election uncertainty.

Our estimations for the first-day price yield even stronger support for *the diminishing demand for equity explanation*. The first-day closing price is lower by even larger amount than the offer price during the election periods (a significant decline of more than \$2 vs. significant decline of

---

<sup>4</sup> There are many IPO studies that try to provide explanations or interpretations for the occurrence of underpricing. Ritter and Welch (2002) provide an excellent review of the theories explaining underpricing. Existence of many explanations for underpricing suggests that it is a complex phenomenon. What matters for our analysis is that underpricing is directly or indirectly related to investors' demand, regardless of whether the investors are rational or quasi-rational. Underpricing can occur in rational setting (see Pastor and Veronesi, 2005; and Yung, et al., 2007, among others) or quasi-rational setting (see Rajan and Servaes, 2003), but its occurrence seems tied to the investors' demand of IPO shares, or to the underwriters' and/or firm's reaction to perceived investors' demand.

<sup>5</sup> The purpose of using the same set-up as with underpricing is to run a "controlled experiment," where the determinants of underpricing (as specified by Loughran and Ritter, 2004) are assumed to affect its two components, as well. Since mechanically underpricing is determined by two variables (offer price and first-day closing price), one of these two – or may be both – variables must be influencing the underpricing results from the underpricing regressions. Including the same control variables in all three equations (underpricing, offer price, and first-day closing price) allows us to obtain more reliable evidence as to which component of underpricing is driving the results.

roughly \$0.5 for the offer price). Our multivariate and endogeneity corrected estimations suggest similar decline in first-day closing prices. So, the investors' demand channel seems to impact the IPO activity, as well.

The rest of the paper is organized as follows. Next section summarizes the literature on policy uncertainty and its impacts. Section 3 explains our IPO data, our election data, and our variables. Section 4 provides evidence of decreased IPO activity under election uncertainty. Section 5 presents evidence of channels through which the uncertainty may impact the firms' IPO decision, and Section 6 concludes our study.

### Figure 1: IPO Activity across the Election Cycle

The figure depicts the total number of IPOs (averaged across the states) issued in each year of the election cycle during our sampling period, 1988-2011. The special elections and the elections conducted in states with 2-year election cycle (NH, RI, and VT) are excluded from the analysis. There are total of 282 elections conducted in 47 states with 4-year election cycle.



