Initial public offering of small companies

Primary, I.P.O underpricing is when company's shares are offered to the public for first time at a price below the price which investors are willing to pay when the shares start trading in the second market. (Espinasse, 2011)
The information asymmetry theory assumes that I.P.O. pricing is a product of information differences. In other words, I.P.O. underpricing occurs because of differences in information. It is a result of imperfect information between investors and issuers. (Cohen & Dean, 2005) Moreover, I.P.O. underpricing of small companies is due to the fact of insufficient information about the company offered to prospective investors. Consequently, investors do not feel secure and think they are taking greater risk when investing in small entities than large ones. (Solomon, 2011)

Another theory suggests that underpriced I.P.O. is associated with weakness of the issuer. Therefore, shares are underpriced in order to compensate the potential investors for that weakness. (Espinasse, 2011) For example, according to the theory, if a company has weak earnings growth it should compensate its investors by underpriced I.P.O.
Additionally, a popular theory assumes that investment banks organize underpricing as a system to benefit themselves and their other clients. (Karlis, 2000)

Furthermore, according to the "lemon theory" by George Akerlof (1970), uninformed investors bid without knowing the quality of the I.P.O. By contrast, informed investors bid only if they will gain greater returns. However, underwriters need uninformed investors to bid due to the scarce number of informed investors. Hence, they reprice I.P.O in order to bring uninformed investors. (Akerlof, 1970)

Lastly, small companies' I.P.O is underpriced owing the possibility of company failure. Usually, small businesses tend to be more risky than larger, well established businesses.

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Generally, I.P.O. is neither cheap nor easy exercise to complete especially when a small business decides to go public. Usually, there are three methods for a company to go public: (1) auction method, (2) fixed-price method and (3) book-building method. (Solomon, 2011)

Evidence shows that under the auction method, I.P.O. is less underpriced. Moreover, the cost of I.P.O. can be slightly reduced by choosing to offer the shares directly to the public without the help of an underwriter. This will eliminate some fees, however it is more risky for small companies because they tend to be less known and recognizable and bids for their shares may be insufficient, which on its turn may lead to failure in going public. (Espinasse, 2011) Best option for small businesses to minimize I.P.O. underpricing is using the book-building method. It is a process by which an underwriter builds a book of potential investors and prices and number of shares they are willing to pay for. (Solomon, 2011)

Another key way to minimize I.P.O. underpricing is to provide enough freely available information about the issuer. Thereby, investors will be able to have clearer picture for the business and its operations. However, the EMH suggests that the information provided should be of reasonable quantity and timely. (riskencyclopedia.com, 2015)

Alternative possible way to reduce I.P.O. underpricing is underwriters allocating shares to sufficient number of informed investors which are able to regard the quality of the I.P.O