RELATIONAL AND MARKET-BASED LEGITIMATION OF INTERNET IPOS

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INTRODUCTION

The ability of organizations to acquire and maintain legitimacy in order to gain access to resources is of critical importance to entrepreneurial firms. A great deal of research has been conducted that focuses on the impact of sources of legitimation such as winning contests (Rao, 1994), developing relationships with established and high status actors (e.g., Baum & Oliver, 1991; Podolny, 1994), and providing accounts attempting to justify potentially threatening outcomes (e.g., Elsbach, 1994). Little research has been conducted in market contexts, however, that explore how the initial responses of the market itself to a firm can serve as a source of legitimacy. In addition, research in this area has tended to focus only on the effects of single sources of legitimacy, and does not provide much insight into how multiple sources of legitimacy could combine to influence the resource acquisition capabilities of an organization. Many of these studies also tend to rely on the relationship between legitimacy and firm survival as evidence that legitimacy leads to greater resource acquisition capabilities (e.g., Rao, 1994; Baum & Oliver, 1991). There has been little research that has explored how specific sources of legitimacy enhance an organization's ability to acquire particular kinds of resources. These studies also often treat legitimacy as an almost "binary" construct (i.e., either a firm is legitimate or it is not), rather than viewing a firm’s legitimacy as ranging along a continuum from less to more legitimate.

In this study, we attempt to address some of these gaps in the literature by exploring the potentially cumulative ways in which firms can acquire legitimacy from two different sources: 1) “market legitimacy” from the social proof (Festinger, 1954; Rao, Davis & Greve, 2001) provided by positive market reactions to the company, and 2) “relational legitimacy” from the social capital available in a firm’s relationships with prominent actors. In doing so, we treat legitimacy in a continuous fashion, and demonstrate how acquiring increasing amounts of legitimacy from different sources can differentially enhance an organization’s access to three different kinds of resources -- social, financial, and operational/productive -- that are all necessary for continued survival and growth (Suchman, 1995). The context used to explore these issues is the initial public offerings (IPOs) of high technology start-up firms.
THEORY DEVELOPMENT

If a firm evinces traits that are consistent with “a generalized perception or assumption that the actions of an entity are desirable, proper or appropriate within some socially constructed system of norms, values, beliefs, and definitions,” it will be considered legitimate (Suchman 1995, p. 574). To the extent that the social group possess resources of value to the firm, being perceived as legitimate by this group can increase the likelihood that the firm will be able to gain access to resources that can enhance the firm's growth and survival opportunities (Rao, 1994). The firm will be granted these resources because it can be reasonably expected to use the resources in ways that are acceptable to those who have granted them (Suchman, 1995).

Underpricing. One avenue, ignored by prior research, through which an organization can gain legitimacy and enhance its access to resources post-IPO is the positive initial reaction of the market to the company's stock -- a phenomenon finance scholars have dubbed “underpricing.” Put simply, underpricing is the percentage difference between the initial price of the stock and the price of the stock at the end of the first day of trading. All IPO firms face strong pressures to attempt to underprice their stock, and most IPOS experience positive levels of underpricing on their first day of trading (Ritter, 2001). Most research that has explored the issue of IPO underpricing has focused on how firms or their close advisors attempt to encourage the dissemination of privately held information about the firm, or compensate investors for accepting the risks associated with investing in IPO stocks (see Ritter [2001] for a review). Ritter (2001) has noted that none of these arguments provide a fully convincing explanation. In addition, these explanations do not hold up particularly well in explaining the magnitude of the underpricing experienced by Internet IPOs. In this study, rather than focusing on the antecedents of underpricing, we focus on the benefits that can arise as a consequence of underpricing, whether intentional or not, and its role as a legitimizing force for newly public firms.

Research on decision making has found that individual evaluations and assessments are often biased toward an initial anchor, and that subsequent adjustments away from the anchor are usually not sufficient to negate the effects of the anchor on their evaluations (Slovic & Lichtenstein, 1971). A firm’s IPO is its first introduction to the capital market, and the way that its stock performs on the first day of trading can create a perceptual anchor that has a powerful, lasting impact on evaluations of the firm's value in the eyes of investors. In addition, under highly uncertain conditions, individuals will often look at what others are doing for confirmation, or “social proof” that their decisions are correct (Festinger, 1954; Rao, et al., 2001). Social proof can thus be an effective mechanism for enhancing organizational legitimacy in uncertain circumstances (Rao et al., 2001). The perceptions of others provide a cognitive anchor around which individuals develop their own evaluative schema, (Festinger, 1954), and the social consensus that results as this process is replicated across a broad group of actors further reduces uncertainties regarding the correctness of the individual evaluations (Rao et al., 2001).

In the context of the IPO market, we argue that social consensus is reflected in the value placed upon a company's stock by investors. Specifically, the degree to which a company is certified as a winner or a loser by the market is reflected in the amount of underpricing the firm experiences on its first day of trading. Abnormally large amounts of underpricing generate positive media
attention and investor momentum that can trigger positive information cascades (Rao et al., 2001). The positive attention that an underpriced firm receives reduces the perceived uncertainty surrounding the firm, and increases its access to resources (Garfinkel, 1993; Rajan & Servaes, 1997). Since the expectations of investors are based on the ill-defined “future potential” of the IPO firm, rather than on more immediate and verifiable measures of performance, there is unlikely to be any new information to disconfirm investors’ initial perceptions of the firm in the near term (Rao et al., 2001). We therefore hypothesize:

**H1:** Underpricing will be positively associated with success in resource acquisition following the IPO.

**Social Capital.** A second way in which firms attempt to acquire legitimacy is through their ties to prominent and legitimate actors and institutions (Baum & Oliver, 1991; Carter & Manaster, 1990; Podolny, 1994). A significant body of work has been developed that demonstrates how ties to actors with substantial reputations and social status can provide a number of benefits for a firm (e.g., Baum & Oliver, 1991; Carter & Manaster, 1990; Megginson & Weiss, 1991). Researchers have suggested that high status actors provide an endorsement of, or certify, that the focal organization is of a certain quality or character, and thus confer legitimacy upon the organization through its association. Because the status and legitimacy of the focal actor is derived from its relationships with other legitimate actors in its social environment, we argue that these relationships provide the focal actor with a valuable source of social capital (Portes, 1998). In the context of the IPO market, two actors that have been found to enhance the social capital of offering firms are underwriters (Carter & Manaster, 1990) and venture capitalists (Megginson & Weiss, 1991). Prior research (e.g., Carter & Manaster, 1990; Megginson & Weiss, 1991) has explored the impact that underwriter and venture capitalist (or VC) certification can have on resource acquisition at the time of the IPO, but has not explored how associations with these prominent actors can be of benefit to a firm in gaining access to resources subsequent to the IPO.

Given that various stakeholders with interests in the IPO market are boundedly rational and cognitively constrained, they are not able to direct their attention equally to all indicators of the legitimacy of a firm. The involvement of these highly legitimate actors with a firm at the time of its IPO could, like underpricing, create a cognitive anchor (Slovic & Lichtenstein, 1971) that has persistent effects beyond their impact on the IPO. Thus, if IPO firms are able to successfully impact initial stakeholder perceptions of their legitimacy by building social capital via their relationships with underwriters and VCs, they may also create a “halo effect” that can be of benefit in acquiring resources following the IPO, as well. We therefore hypothesize:

**H2:** Underwriter reputation and venture capitalist backing will be positively associated with success in resource acquisition following the IPO.

**Cumulative Effects of Different Sources of Legitimacy**

Prior research on information acquisition for use in sensemaking has suggested that noticing may reach threshold levels, after which the increasing novelty or repetition of the stimulus does not generate further increases in attention (Starbuck & Milliken, 1988). Research on noticing and attention has found that repeated exposure to similar stimuli can result in a decrease in the level
of noticing of the stimuli. People become less sensitive to stimuli as it becomes familiar (Starbuck & Milliken, 1988), and to the extent that information ceases to stand out (Fiske & Taylor, 1991). This research has implications for how stakeholders are likely to react to multiple sources of legitimacy. It suggests that, as individuals become exposed to multiple indicators of legitimacy about a firm over time, they will pay less attention to later indicators if they do not provide information that is somehow novel, or that stands out in contrast to prior indicators. If this is the case, multiple sources of legitimacy may effectively serve as partial "substitutes" for one another in reducing some portion of the uncertainty surrounding the firm.

In the context of this study, social capital is acquired before the amount of underpricing is experienced. If a firm’s social capital has already addressed some of the same areas of uncertainty in the minds of stakeholders that would be addressed by underpricing, experiencing greater levels of underpricing may not yield a concomitant increase in the ability of the firm to acquire resources following the IPO. This suggests the following hypothesis:

**H3:** The effect of underpricing on a firm's success in acquiring resources following its IPO will be reduced by the firm’s social capital.

However, an alternative argument is also plausible. It is possible that the two sources of legitimacy, if they overlap, serve to validate and support each other, and provide the observer with greater confidence in his/her expectation that the organization is indeed a legitimate actor worthy of their resources. Research in social psychology has found that repeated exposure to information increases an actor's familiarity with, and subsequent liking of, the subject, and reduces perceptions of the riskiness of the activity (Fiske & Taylor, 1991). In the context of IPOs, this suggests that underpricing would serve to reinforce, or validate, the social capital acquired through relationships with underwriters and VCs. This line of reasoning suggests the following, competing hypothesis:

**H4:** The effect of social capital on a firm's success in acquiring resources following its IPO will be enhanced by higher levels of underpricing.

### DATA AND RESEARCH METHODS

Our sample consisted of Internet firms that conducted IPOs between January 1, 1995, and September 30, 2000. We defined an Internet firm as a company that was founded with the intention of focusing on the Internet in defining its primary line of business and generating the majority of its revenues. Firms that currently generate a substantial proportion of their revenues from the Internet, but that were not founded with the intention of being primarily Internet-focused, were not included in our sample. We also excluded companies that were spin-offs of publicly held companies. Our final sample included 423 companies.

Three dependent variables were considered in this study: 1) Whether or not a firm conducted a Secondary Offering; 2) the Number of Post-IPO Strategic Alliances the firm entered into; and 3) the Number of Analysts Following the Firm 6 months after its IPO.
Two independent variables were used to operationalize social capital: 1) Underwriter Reputation, which was operationalized using the index developed by Carter & Manaster (1990), and 2) a Venture Capital Backing dummy variable. Our third independent variable, Underpricing, is defined as the percentage change in stock price between the initial price set for the stock and the closing price on the first day of trading. We logged this measure because the presence of extreme values might impact our findings. Because some of the underpricing values are zero or negative, a 44 was added to all observations prior to logging. We also included the following control variables in our models: Year dummies, industry dummies, a dummy for companies located in California, the number of pre-IPO alliances, firm age, total value of the IPO, and, for the analyst regressions, six month firm stock returns and market performance.

Logistic regressions using Stata 7.0 were used to test the models predicting whether or not a firm conducts a secondary offering. Because our other two dependent variables were count measures, which are seldom normally distributed, we used negative binomial regressions to test the models predicting these variables.

RESULTS

The results of our analysis (not reported here) were generally supportive of Hypotheses 1 and 2, and provided some support for Hypothesis 3. Underwriter reputation was positively associated with conducting a secondary offering and the amount of analyst coverage received, and both VC backing and underpricing were positively associated with the number of post-IPO strategic alliances and the amount of analyst coverage received. Underwriter reputation also had a negative moderating effect on the relationship between underpricing and analyst coverage.

CONCLUSION

This study has extended research on the role of legitimacy in market activities by exploring the different sources of legitimacy available to Internet companies as they conduct initial public offerings, and how they can be combined to impact a firm's access to social, financial, and operational resources following its IPO. Our findings suggest that a firm's legitimacy can be enhanced both by associating with prominent advisors, and by being certified by the market through its response to the firm's IPO. Our results also show that different sources of legitimacy can be more or less useful in acquiring particular types of resources, and that different sources of legitimacy can, in some instances, be used as substitutes for one another. These findings have theoretical implications both for understanding the process by which organizations acquire legitimacy, and for understanding the role of organizational legitimation in resource acquisition activities in market contexts. They also take a step forward in furthering our understanding of how economic markets are socially constructed.

REFERENCES


