

# Wanna Dance? How Firms and Underwriters Choose Each Other

## ABSTRACT

We develop a theoretical model founded on the idea that issuers and underwriters associate by mutual choice, an approach that contrasts with the conventional view in the literature of firms picking their underwriters. Underwriters look to the quality of the issuers who may wish to employ their services and issuers look to the abilities of the underwriters they consider employing. We derive several new results. First, our model predicts and our empirical tests confirm that the association of issuers and underwriters is transactional and that switching is bi-directional. Thus, whether firms switch or stay with the same underwriter for a secondary offering is determined by the relative change in quality of the firm and the relative change in reputation of the underwriter from IPO to SEO. After controlling for the change in underwriter reputation between IPO and SEO, we find that the change in the firm's relative quality is highly significant in explaining the switch throughout our sample period. In particular, we find that issuers who experience a relative reduction in quality from IPO to SEO switch to lower reputation underwriters for SEO offerings. Second, while existing studies link underwriter market share to past performance, we derive new implications about underwriter market share based on current market conditions, showing that the market share of high reputation underwriters is negatively related and the quality of issues they underwrite is positively related to overall issue activity, causing high reputation underwriters to earn a more stable revenue stream than their less reputed counterparts. Third, we show that many underwriting spread patterns are consistent with equilibrium in our model, including a uniform flat percentage fee charged by all underwriters. Additionally, the model predicts (and our empirical results show) that for SEOs, the percentage spread will be negatively related to the reputation of the underwriter. Nonetheless, our model also predicts that high reputation underwriters will earn higher dollar revenues from their client firms through security issues that are both larger and more frequent, which we also confirm through our empirical tests.