Initial Day Return and Underpricing Cost in Advance Payment Initial Public Offerings

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Summary

Hong Kong represents the second largest of the initial public offering (IPO) markets that adopt an advance payment subscription procedure. The lengthy process creates substantial financing costs to investors but interest earnings to issuers. Data from a sample of 386 IPOs listed between 2000 and 2007 reveals that interest cost can reduce the return to public subscribers by 44%, while the HIBOR-based interest earnings to issuers are estimated at 0.59% of funds raised, and at 6.27% of forecast earnings. Consistent with Agarwal, Liu, and Rhee (2008), the realized subscription rate strongly influences returns but the link weakens at higher interest rates. Interest earnings and underpricing are highly correlated, a finding in support of Chowdhry and Sherman's (1996) proposition. However, the proposition is deemed irrefutable as both underpricing and interest earnings are highly related to the subscription rate. Moreover, regression results show that the relationship between the subscription rate and offer price of H-shares and red-chips are indistinguishable from other issues. These results cast doubt on the common conjecture that the management of China-related enterprises are more likely to underprice their offerings than the managers of other enterprises. The higher returns to H-share and red-chip stocks may be attributable to the higher public demand for large issues.