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Pacific-Basin Finance Journal 14 (2006) 484 – 500
PACIFIC-BASIN FINANCE JOURNAL
www.elsevier.com/locate/pacfin

Changing conditions in the Hong Kong new issues market

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Received 8 April 2004; accepted 21 February 2006
Available online 5 June 2006

Abstract

This paper examines the Hong Kong IPO market from August 1995 to July 1999 and finds that the time of the June 30 1997 political handover coincides with the transition in the IPO market from 'hot' to 'cold'. Although the handover was an anticipated event, an explanation for the change in market is that the political handover created uncertainty among investors; a type of information asymmetry where all investors faced greater uncertainty. Our finding provides empirical support to literature which proposes that events in the months preceding the October 27 1997 correction in Asian stock markets facilitated a decline in confidence in financial markets, subsequently characterised as the 'Asia Financial Crisis'. In addition, we find initial returns of newly listed stocks in the Hong Kong market are associated with market condition but not associated with any particular industry (i.e., PROPERTY) or geographic location (i.e., 'H' SHARES) suggesting that the prevailing market condition was spread more generally across issues.

JEL classification: G24; G32
Keywords: Asian Financial Crisis; Market condition; Initial public offerings; Underpricing

1. Introduction

Hong Kong has a mature and well regulated capital market which is among the ten largest in the world. The procedure for making a public offer and listing on the stock market is similar to that of many British Commonwealth countries.[2] Issues are normally underwritten and fixed

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[2] See Cheng and Firth (2000) for a summary of the procedures used in floating a company on the Stock Exchange of Hong Kong.

0927-538X/$ - see front matter © 2006 Published by Elsevier B.V.
doi:10.1016/j.pacfin.2006.02.003

pricing is used as opposed to a book building approach. Consistent with international research, Hong Kong studies find investors in Initial Public Offerings (IPOs) typically experience systematic profits when these issues commence trading. This phenomenon, commonly known as ‘underpricing’, is a feature of financial markets worldwide. Factors found to be associated with underpricing include IPO risk, quality, investor interest, size, industry and the state of the market or market condition (i.e., ‘hot’ or ‘cold’ market). Research consistently finds higher returns in ‘hot’ compared with ‘cold’ markets (see for example Ibbotson et al., 1994). However, the methods used to identify ‘hot’ or ‘cold’ markets typically do not allow for the identification of a precise point of transition.

This study investigates the transition in the Hong Kong IPO market during the period August 1995 to July 1999. The period under review includes a number of unique events making measurement of market condition problematic. Politically, 1997 marked the Handover of Hong Kong to Mainland China on June 30, 1997 after a century’s governorship under the United Kingdom. This long anticipated political event, representing a particular type of information asymmetry, created uncertainty in financial markets. Economically, it marked the historic high of the Hang Seng Index on August 8 1997, just two months prior to the October 27 stock market correction and its resulting turmoil. Conventional wisdom is that the October 27 market correction signalled a turning point in the Hong Kong stock market. However, Chowdry and Goyal (2000) and Miller (1998) propose that the financial situation elsewhere in Asia started to deteriorate in the months prior to the October 1997 correction in Asian stock markets. Hence, there is uncertainty as to whether economic or political factors were the catalyst for the changing condition in the Hong Kong IPO market. This study aims to identify empirically at which point the Hong Kong IPO market transitions from ‘hot’ to ‘cold’. General financial market uncertainty could explain a transition around the time of the handover.

We demonstrate that the precise date of transition from ‘hot’ to ‘cold’ is unclear using traditional approaches to measuring market transition based around the underlying securities market index or characteristics of the IPO market including initial return, IPO volume and proceeds (see for example Benveniste et al., 2003; Derrien and Womack, 2003; Brailsford et al., 2000; Ibbotson et al., 1994; Ritter, 1984; Ibbotson and Jaffe, 1975). Applying an econometric technique devised by Hansen (2000) we identify the structural break in the IPO return series that signifies the transition from ‘hot’ to ‘cold’ market. Following this we use a standard Ordinary Least Squares (OLS) linear regression model to confirm the significance of market condition to IPO underpricing, controlling for risk (using ex ante uncertainty, the number of years in operation before going public and leverage); investor interest (number of days between registration and listing); quality (reputation of underwriter, auditor and independent expert); size (issue proceeds); class of share (e.g., ‘H’ SHARES) and industry. Therefore a further contribution of this study is to provide an examination of the initial after market performance of Hong Kong IPOs at a unique and as yet unexamined time.

The paper is divided into five sections. In Section 2 we review the literature on ‘hot’ and ‘cold’ IPO markets, Hong Kong IPOs, and provide motivation for the study. Section 3 outlines the research method employed. In Section 4 we analyse results of the statistical tests employed and we conclude in Section 5.

2. ‘Hot’ and ‘cold’ markets and Hong Kong IPOs

The relationship between ‘hot’ issues markets and underpricing is well documented in IPO literature. Ibbotson and Jaffe (1975) propose that ‘hot’ issues markets are characterised by a large