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# Investor sentiment and IPO pricing during pre-market and aftermarket periods: Evidence from Hong Kong



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### ABSTRACT

Using a sample of 293 IPOs in Hong Kong, we separately measure pre-market and aftermarket sentiments and examine their impact on IPO pricing in a two-stage framework. We find that underwriters only partially adjust offer price to reflect pre-market sentiment and money left on the table is positively related to the deterioration of investor sentiment in the aftermarket period. We also show that aftermarket sentiment causes a further price run-up in the secondary market. Overall, our findings suggest that institutional investors play an important role of re-distributing shares in the secondary market and underwriters take into consideration of investor sentiment in pricing IPOs during pre-market and aftermarket periods.

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## 1. Introduction

IPO underpricing phenomenon has been studied extensively in the finance literature. So far, evidence has shown that investor sentiment is an important determinant for IPO pricing and underwriters take advantage of investor sentiment by setting an offer price above its intrinsic value (Derrien, 2005; Cornelli et al., 2006; Ljungqvist et al., 2006; Cook et al., 2006; Dorn, 2009). In this study, we show that it is important to examine investor sentiment separately during pre-market and aftermarket periods.

A recent study by Chen and Wilhelm (2008) focuses on the transition from pre-market bookbuilding to the secondary market trading, to account for sequential arrival of informed traders. Underwriters adopt a staged distribution strategy in order to circumvent the restriction of a uniform offer price and to extract greater surplus from informed investors over time. We adopt a similar two-stage framework to account for

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the possibility that sentiment investors may also arrive sequentially and pre-market sentiment may deteriorate during the aftermarket period. The transition from primary to secondary markets gives rise to an important role played by regular investors to re-distribute shares to sentiment investors in the secondary market (Ljungqvist et al., 2006). Thus, to extract greater surplus from sentiment investors over time, underwriters also adopt a staged distribution strategy. However, the fact that most of prior IPO studies on investor sentiment use initial return (i.e., offer-to-close return) on the first day of trading implies that the transition process from pre-market stage to aftermarket trading has not been properly considered.

In this study, we fill this gap by separately measuring pre-market and aftermarket sentiments and examining their impact on IPO pricing in the two-stage framework. We address two important questions: First, whether and how would compensation for regular investors explain partial adjustment of offer price to investor sentiment? Ljungqvist et al. (2006) argue that underwriters partially adjust offer price to reflect not only investor sentiment but also the risk of deteriorating sentiment. The greater the chance for a “hot” IPO to end prematurely, the more the money left on the table for regular investors. By partitioning the transition process into pre-market and aftermarket stages, we can empirically test their prediction. In particular, if institutional investors anticipate a deterioration of investor sentiment in the aftermarket, they would demand a higher compensation for re-distributing shares in the secondary market. Second, why would investors (sentiment investors in particular) pay an even higher price than offer price when trading starts in the secondary market? If investor sentiment persists into the aftermarket stage and divergence of opinions increases, investors might be willing to chase hot issues in the aftermarket period as long as more optimistic sentiment investors are expected to arrive sequentially.

Hong Kong provides a unique institutional setting to study investor sentiment and its impact on IPO pricing. First, Hong Kong IPOs have a Dual Tranche system with Public tranche for retail investors and Placing tranche for institutional investors. The retail demand for public tranche is presumably driven by investor sentiment. Thus, the availability of subscription rate for public tranche allows us to have an effective proxy for pre-market sentiment. The fact that retail investors have a prominent presence also makes Hong Kong an ideal place to study the impact of investor sentiment on IPO pricing.<sup>1</sup> Second, Clawback Provision in Hong Kong implies that the allocation to institutional investors is inversely related to retail demand (or pre-market investor sentiment). Clawback Provision generates a greater variation in the fractional allocation to regular investors in Hong Kong, as compared with a more stable allocation of 70% in the US. This allows us to examine how regular investors are compensated in the presence of fluctuating sentiment.

Our study proceeds as follows. First, we posit that underwriters revise offer price to incorporate pre-market sentiment. We find that offer price revision is positively related to oversubscription and investor attention. However, offer-to-open return remains positively related to pre-market sentiment, suggesting a partial adjustment of offer price to pre-market sentiment. Second, we posit that institutional investors are compensated for their role in the staged distribution of new shares in the secondary market. We show that offer-to-open return (or the amount of money left on the table) is positively related to the deterioration of investor sentiment from pre-market to aftermarket periods. Our findings provide an explanation for the observed partial adjustment phenomenon and confirm the prediction by Derrien (2005) and Ljungqvist et al. (2006). Third, we posit that aftermarket sentiment pushes stock price higher. We use small trade order imbalance and turnover as proxies for aftermarket sentiment. While small trade order imbalance captures retail investor overconfidence, divergence of opinions captured by trading volume in conjunction with short-sales constraints causes overpricing (Miller, 1977). Our findings support our prediction of a positive impact of aftermarket sentiment on secondary market returns.

Our study contributes to the literature on investor sentiment and IPO pricing in the following ways: First, by focusing on the transition from primary market to secondary market, we capture changes in investor sentiment surrounding the IPO listing. Second, we identify sources of investor sentiment at different stages: Investor attention appears to drive retail demand at the pre-market stage, whereas divergence of opinions in conjunction with short-sales constraints is likely to cause overpricing in the secondary market. Third, by connecting pre-market sentiment to aftermarket sentiment, the two-stage framework allows us to establish a relation between compensation for institutional investors and anticipated reversal of investor sentiment over time. We shed lights on an important role played by institutional investors in re-distributing new shares in the secondary market.

<sup>1</sup> Huang et al. (2011) suggests that Asian markets are more prone to investor overconfidence.

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