

## MASTER'S THESIS

### Listing day return and underpricing cost for China enterprises in advance payment initial public offerings

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**Listing Day Return and Underpricing Cost for  
China Enterprises in  
Advance Payment Initial Public Offerings**

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## ABSTRACT

The Hong Kong market was ranked second in 2006 and first in 2009 in terms of the amount of capital raised through initial public offerings (IPOs). Hong Kong IPOs attract large public interest and the new issues are always highly oversubscribed. Previous studies show that the initial day return to Hong Kong IPOs generally exceed those observed in the US and European markets; however, most research has failed to factor in the differences in the subscription processes across different markets. Hong Kong adopts non-discretionary allocation system. Public subscribers incur significant financing costs since they are required to pay in advance for the share value. The advance payment requirement makes the conventional IPO return measurement provides an upward biased to public subscribers. Extending Fung Cheng, and Chan (2004), the study finds that the initial day returns significantly drop from 12% of conventional measure to 9% if HIBOR is used to represent the financing cost. Chowdhry and Sherman (1996) suggest that interest earnings induce issuers to underprice their issues for advance payment IPOs. A conjecture to this proposition is that China enterprises may further underprice their issues since the management is not the major shareholders and they get credit directly from better earning result. This study finds that H-shares register a significant higher average return. However, regression tests show that the higher return to H-shares is attributable to the relatively larger issue size. The excess demand, using the realized subscription rate as a proxy, subsumes all the variables in explaining the variations in the listing day returns, a result largely consistent with Agarwal, Liu, and Rhee (2008). Moreover, the excess demand can be largely explained by a size variable and the previous IPO return. Overall, this study finds that interest earnings contribute to the forecast earning by 5%. However, the HIBOR-based interest income is only of 0.59% of the total fund raised. The underpricing cost reduced by 66 bps and become 11.26% after adjusting for HIBOR interest. The results cast doubt on the Chowdhry and Sherman's (1996) argument.

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