

ABSTRACT

In Hong Kong, underpricing of initial public offerings (IPOs) is common. One study performed by the stock exchange of Hong Kong indicates that over 85% of the new offerings between 1988 and 1992 were underpriced (Leung, 1992). In our study, we aim at finding explanations for this contradiction to market efficiency.

Specifically, we are interested in testing whether the Pricing and Allocation schedule of Benveniste and Spindt (1989) can be used to explain the level of underpricing of new offerings in Hong Kong. In addition, several variables are examined to see how they behave in relation to the setting of final offer price and initial returns.

Data were gathered from various sources: fact books, newly quoted companies' prospectus, newspapers, and securities journals. The results of our analysis show that the proposed compensation schedule is not exercised by underwriters in pricing initial public offerings in Hong Kong. Also, in determining the final offer price of new issues, four variables are important: Market Index, Proposed P/E Ratio, Proposed Dividend Yield and Proceeds From the Offerings. While the first and fourth variables have a positive relationship with the final offer price, the remaining two have a negative relationship. In explaining the initial level of returns of new offerings, we also found four significant variables: Warrants, Proposed P/E Ratio, Subscription Level and Proceeds From the Offerings. Of them, only Warrants and Proceeds have a negative relationship with the initial return.

Another interesting result of our study concerns the variable Proposed P/E Ratio: issues with a high P/E ratio have lower subscription price but their after-market price performance is better. This can be attributed to underwriters' risk averse attitude. Underwriters, in order to minimize losses arising from any unsold share, have purposely set the price lower. Realizing the existence of such bargain price, investors will make purchase. Thus the initial returns will be boost up by the excess demand.