

Special Issue on Initial Public Offerings

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The topic of initial public offerings generated extensive academic research first in the U.S. during the 1970's and 1980's. This early theoretical and empirical work produced interesting theoretical explanations on the most important empirical finding about IPOs, namely, the persistence of underpricing. Subsequent work also uncovered other puzzling phenomena, as for example, the long-term stock price underperformance of new issues and the existence of "hot market" periods, when the underpricing is excessively high. The significant volume of work on new issues conducted on foreign markets was built on this earlier research and was due to two important developments. First, the wave of privatizations of previously state-owned enterprises, which intensified in the late 1980's and continued through the 1990's, and second, the world-wide raising of substantial sums of equity in public markets by privately owned corporations.

This special issue on IPOs contains five papers that report empirical findings from different countries.

An important feature of the market for IPOs, documented in several capital markets, is the tendency of the market to undergo periods of concentrated activity, whereby the number of new issues coming to the market and the extent of underpricing both appear to substantially increase. These "hot issue" periods generate strong interest and attention because of their perceived potential for short term trading profits. Yet, little attention has been directed towards the formal identification of hot and cold IPO markets. Tim Brailsford, Richard Heaney, John Powell and Jing Shi analyze the behavior of the U.S. IPO market over the period 1976 to 1998 to formally document the existence of hot and cold

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issue periods and to examine different characteristics of the market, focussing on the volume and underpricing of new issues, in order to provide a multi-dimensional characterization and identification of hot and cold IPO markets. By using a regime-switching model that dates transitions between hot and cold states, and by using a variety of IPO activity measures that capture different aspects of IPO volume, proceeds and underpricing, the authors identify a number of hot periods over the 20-year period under analysis. They further document a leading relationship between underpricing and IPO volume of up to six months, supporting the contention that the decision to issue is a function of current underpricing. The authors hypothesize, and their evidence confirms, that current underpricing contains relevant information which the issuers and/or underwriters take advantage of. Indeed, VAR analysis identifies the lags of stock market conditions and business conditions as explanatory variables of the number of new issues. Furthermore, the authors report a strong autocorrelation in the underpricing series and a significant relationship between underpricing and lags of stock market returns, implying that current stock market conditions provide some predictive power over the degree of future underpricing which is valuable information to issuers, underwriters and investors. These findings constitute as significant contribution to the literature because they provide new insights into the IPO market.

Previous research has demonstrated that less informed investors are less likely to receive allocations of underpriced new issues. However, there has been no evidence regarding the factors that seem to influence the demand of different types of investors across IPOs. "An Analysis of Factors Affecting Investor Demand for Initial Public Offerings in Singapore" by Eng and Aw addresses this issue. Their findings show that although large (usually institutional) investors consider value fundamentals in their demand of IPOs, they are more likely to demand issues which subsequently are underpriced and perform poorly in the long run. The opposite is true of small investors who seem to direct their demand towards issues which are less underpriced but do better in the long run. This evidence, coming from an IPO market where the subscription method is used, provides additional insight into Rock's premise that uninformed investors fail to consistently choose underpriced issues.

In "The Relationship between Overallotment Options, Underwriting Fees and Price Stabilization for Canadian IPOs", Richard Chung, Lawrence Kryzanowski and Ian Rakita explore the relationship between

overallotment options (OAOs) and underwriting fees, and between OAOs and price stabilization for a sample of Canadian IPOs that were listed on the Toronto Stock Exchange (TSE) over the period 1984-1993. Unlike the case for U.S. IPOs, the authors find evidence that the OAO has a positive impact on the fees charged by underwriters of Canadian IPOs when they control for factors such as issue size, underwriter reputation and issue risk. According to the authors, this is possibly one reason why Canadian firms are more reluctant to grant OAOs than U.S. firms. Another possible, but completely untested, reason is the associated significant wealth accumulation to large block shareholders and corporate management of U.S. firms brought about by the exercise of the OAOs in the case of underpriced IPOs. As the authors state, IPO underpricing in Canada is virtually the lowest of any industrialized country in the world, and IPO underwriting fees are lower and less concentrated in Canada compared to the U.S. Since the likelihood of significant wealth accumulation for principals of Canadian firms is substantially less than that for principals of U.S. firms, Canadian firms going public may be expected to agree less often to the inclusion of additional marketing incentives (such as OAOs) to underwriting arrangements. While some evidence of stabilization in the market for new equity issues in Canada is uncovered, no significant difference between the differences in mean returns for the OAO sample compared to the No-OAO sample are found. Thus, OAOs are probably used more to aid distributional motivation than to aid price stabilization in Canadian markets. The overall conclusion from this study is that the role of the OAO differs markedly for IPOs in Canadian versus U.S. markets.

It is well accepted that the underpricing of IPOs is mostly due to the ex ante uncertainty about the financial performance of the new issue. One way to capture this uncertainty is the forecast error of post-issue cash flow gauges like revenues and profits. Hartnett and Romcke show in "The Predictability of Management Forecast Error: A Study of Australian IPO Disclosures" that unexpected industry conditions, proposed uses of funds and auditor quality are significant determinants of forecast error. This supplements existing evidence that these factors also influence the IPO underpricing. The paper also presents the interesting finding that using these explanatory variables to predict the forecast error of individual issues has no statistical merit. Therefore, the authors conclude that the usefulness of forecasts in prospectus disclosures appears to be questionable.

In "Privatization versus Private Sector Initial Public Offerings in

Poland," Wolfgang Aussenegg presents evidence on both the short- and long run stock return performance of Polish privatization public offerings (PIPOs) and private sector IPOs. It is interesting that the sample of PIPOs includes all the privatizations in Poland since its transition to a free market system. Besides other interesting findings, this paper shows that in its conduct of privatizations, the Polish government sought to convince the markets of its long-run commitment to private enterprise. This was done by selling a high fraction of equity early on and accepting a large underpricing. Accordingly, public issues of privatized firms in Poland do not exhibit the usually observed long-run return underperformance.

It is our belief that the papers contained in this special volume enhance our understanding of several important issues of IPOs. We hope that you will enjoy reading them, and that they will stimulate your intellectual curiosity to pursue further research in this area.

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