HOW PRIVATE COMPANIES GO IPO ON THE HONG KONG STOCK MARKET?

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ABSTRACT

As more and more mainland private enterprises choose to go IPO in Hong Kong Stock Exchange nowadays, it is meaningful to illustrate the general procedures and considerations of listing in Hong Kong. Our paper provides a general description of these issues through a case study — Wumart Store, Inc., a mainland private company in retail industry. We also conduct a research on IPO underpricing and Post-IPO performance by a sample pool of 20 companies. IPO underpricing is a general phenomenon among these companies. Using the same sample pool, we explore the Post-IPO performance with a period of one year.

TABLE OF CONTENTS

TABLE OF CONTENTS

LIST OF ILLUSTRATIONS

LIST OF TABLES

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CHAPTER 1: INTRODUCTION

With the continuous development towards a market economy, many Chinese private enterprises have entered into a flourishing phase. According to the All-China Federation of Industry & Commerce, the Chinese private business sector contributed more than 60% to the national economy in 2004.

However, the process of their expansion has never been unobstructed, as many of these private enterprises are having funding difficulties. Initially, the source of funds comes from deposits or loans from the personal network. At this phrase, the scale of companies is relatively small and the need of funds is not the primary concern. Nonetheless, more and more funds are needed eventually for further development to achieve a certain level of growth and expansion. In the following, a case of Wumart Stores, a Chinese private company which has listed successfully on the Hong Kong Capital market will be analyzed. Our aim is to demonstrate how a large scale Chinese private company with healthy operations can overcome funding obstacles through listing.

Wumart Stores is a private company, in which its main business is operating a retail chain. The company was founded by Dr. Zhang Wenzhong on August 9, 2000. In November 21, 2003, Wumart Stores was successfully listed in the Growth Enterprise Market (GEM) of the Hong Kong exchange. The funds raised through

Initial Public Offerings (IPO) amounted to 547,061,440 HK$ and the offering was 152.30 times oversubscribed, contributing to its major listing success.

Chapter 1 is the introduction.

Chapter 2 is the general description of IPO process. Practical issues concerning IPO such as pros and cons of public offering, selection of advisors, and reorganization are discussed.

Chapter 3 is the methodology. Data sources and research period are summarized.

Chapter 4 is the analysis of underpricing extent for different companies of the retail sector of Hong Kong Stock Exchange.

Chapter 5 is the analysis of post-IPO performance for the same sample pool. This section also explores the relationship between IPO underpricing and post-IPO performance.

CHAPTER 2: GENERAL DESCRIPTION OF IPO PROCESS

REASONS FOR LISTING

Generally speaking, private enterprises have two choices in raising funds: equity financing and/or debt financing. Under the current Chinese financial system, both channels are not easily accessible for private enterprises.

Debt Financing

Theoretically, there are three channels for debt financing: (1) banks or other financial institutions, (2) bond issuance and (3) private sources. In reality, due to the credit management mechanism and the current banking regulation system, all these channels seem to be difficult to be approached by the private companies. As for bond issuance, the current Chinese bond market is still immature and rigidly regulated. Thus, almost no private company has ever raised money through the bond market. Comparatively, borrowing from private sources is more feasible. However, there are still two major obstacles: (1) the funds are too small and fragmented to satisfy the financing needs of larger private companies, and (2) the legal system is insufficiently developed to protect the involved parties.

Equity Financing

There are mainly two ways for private companies to raise funds through the issuance of equity, and they are private placement and the public offering. Private placement is comparably more popular because of its simpler procedures. Potential investors include individual investors, venture capitalists, investment companies and other corporate investors. On the other hand, public offeringis more demanding, in terms of the quality and the scale of the private companies.

Comparison between the IPO and Debt financing

In weighing the advantages and disadvantages (See Table 1) of different financing methods, private companies have to take their own conditions as well as the external capital market into account. When a private company determines its optimal financial structure, the following key factors should be considered: capability to raise capital, usage and amount of capital, cost of financing, and flexibility of alternatives. Obviously, issuers also need to think about the sustainability of the financing way, profitability of investment project, the regulatory policies, and its current situation in the financial market.

Table 1: Comparison between IPO and Debt Financing

	IPO	Debt Financing
Pros	1. No need of credit rating and collateral 2. Improvement on Debt ratio, liquidity ratio and leverage ratio 3. Reputation increased in both the industry and the financial market 4. Easier to refinance in capital market 5. No interest expenses, no payback pressure 6. High liquidity for shareholders 7. Potential access to different capital markets of different countries and regions at the same time 8. Dividends are exempted from income taxation	1. Preserved equity and corporate control 2. Deductible interest expenses 3. Shorter process 4. No complicated and rigid listing rules and surveillance 5. No risk of hostile takeover
Cons	1. Original shareholders have to release at least 25% of shares 2. Long duration (2-3 years in Mainland china, 1 year in HK) 3. Complicated and rigid listing rules and surveillance 4. High cost 5. Risk of hostile takeover	1. Uncertain interest expenses, in case of floating rate issuance 2. Rating needed, assets have to be pledged 3. Pressure of paying interests and principal, risk of bankruptcy

Background of Wumart

The mission of Wumart Stores is to develop China's own retail industry, and improve the public's living quality, and its vision is to become one of the leading integrated retail network operators in the People's Republic of China (PRC).

To achieve its ambitious missions, Wumart Stores has planned and implemented a series of expansion projects. These projects included: expanding Wumart's retail network in China, building up "Wumart" as a nationwide retail brand, enhancing Wumart's operations, information and logistics systems, and improving the quality of Wumart's human resources. In order to implement these projects, Wumart was in need of a large amount of funds. However, Wumart's capability to raise from debt markets was not very strong because of its private company's status and its limited collateral. On 31 May 2003, right before its listing, Wumart's fixed tangible assets amounted to a mere RMB 54.9 million. Being a retail chain company, expansion was rightly a reasonable and necessary business strategy. Thus, Equity financing seemed to be a favourable tool to seek funds and refinance.

SELECTION OF CAPITAL MARKET

Once private companies have decided to have IPO, they must consider which stock exchange to list on. For Chinese private companies, there are primarily four accessible stock markets: Domestic A share stock market, Hong Kong stock market, Singapore stock market and National Association of Securities Dealers automatic quotation market (NASDAQ). We will discuss the four stock exchanges according to the following nine perspectives:

Consideration 1: Time span of IPO

To be listed on Hong Kong stock market, it generally takes within one year. However, as more and more Mainland companies seek listing status in this market, the time span has been increasing. For Singapore stock market or NASDAQ, the time span is relatively short, generally 6-9 months. In case of China A shares, due to a large number of applicants, a company must enter a queue to be listed. The shortest time exceeds 2 years including one year of tutoring period.

Consideration 2: Consecutive management operations

The stock markets of Hong Kong, China A share and Singapore all require the candidate company to have three years of consecutive operations. During the three years period, the top management, the shareholders, and the key technicians should maintain stably to demonstrate that the company is of high quality and mature, while there is no such specific regulation for NASDAQ.

Consideration 3: Requirement on consecutive holding

According to Hong Kong's listing rules, the issuer should maintain its shareholder status for at least 1 year. During the first half of the year, the controlling shareholders are forbidden to sell their shares, and during the second half of the year, the controlling shareholders are restricted to sell out the amount of shares which make them lose the controlling status. The restrictions also apply to the China A share stock market, but not the Singapore stock market or NASDAQ.

Consideration 4: IPO pricing

In the Hong Kong stock market, the offer price is based on the company's operating performance as well as the market environment, without any ceiling or floor. During pricing, the model of profit prediction is extensively adopted. PE ratio of issues is ranged between 10 and 20. In this aspect, the Singapore stock market is very similar, while its PE ratio would be around 10.

The China A share market has a more complicated system. According to Mainland regulation rules, the PE ratio of IPO should not exceed 20 and the funds raised should not amount to more than twice of the company's net assets. Instead of an estimated future profit, historical profit data are used to determine the offer price.

Further, an empirical research for Chinese companies the PE ratio of issues on NASDAQ is slightly higher than the ones of Hong Kong and Singapore.

<u>Consideration 5: Seasoned issue</u>

In Hong Kong, the company is not allowed to have seasoned issue within 6 months after the IPO. Thereafter, there will be no time limitations as long as the seasoned issue is approved by the board or at the shareholders meeting. Likewise, there is a similar restriction for the Singapore stock market, but it is only limited up to3 months of time. As to the China A share stock market, the company can only pursue a seasoned issue once a year and the regulations on seasoned issues are very strict, including minimum ROE requirements. Besides, the issuance of options and derivatives is prohibited in this market.

<u>Consideration 6: Market liquidity</u>

In terms of liquidity, the Hong Kong stock market is ranked the top. All shares of listed companies are tradable in the Hong Kong stock market. . In 2003, the average trade volume per day was USD1.3 billion. Although the shares in Singapore are also tradable, its liquidity is not as high as in Hong Kong. Its daily average trade volume only amounted to USD90 million. In China, not all the shares can be traded in full on A Share stock market, especially the listed state-owned enterprises (SOE). These shares are known as circulation shares. National shares and corporate shares cannot be traded in the market under the current system and it will take issuers three years before they sell. The daily average trading volume in 2004 amounted to

USD1.312 billion. For NASDAQ, all shares of listed companies can be traded freely. The trading volume for Asian companies is comparatively small and the degree of liquidity is low due to unfamiliarity.

Consideration 7: Company image

Basically, successfully listing in Hong Kong, Singapore or NASDAQ can help enhancing the international reputation, while listed in China can only promote the company's image nationally and its international influence would be limited. However, the Hong Kong stock market would be considered to be the only platform, which can improve the company's image both nationally and globally. Mainland

Consideration 8: Investors

Investors in Hong Kong are more familiar with the main land companies' information and easily understand the general performance. Professional analysts in this market are generally highly qualified and can provide a high level of analysis. Investors in Singapore are less familiar with companies from the Chinese Mainland. Some professional analysts cover Chinese listed companies, but not as many as in Hong Kong. Investors in the China A share stock market are the most familiar with the Chinese companies. However, the analysts' level of qualification is considerably lower than those in international stock markets. Furthermore, since the market's inception credibility and integrity standards have been generally low, investors in NASDAQ stock market are the least familiar with Chinese.

Consideration 9: Market Capitalization

By December 31, 2004, the total market capitalizations of the Hong Kong stock market, the Singapore stock market, the China A share market and NASDAQ amounted to USD 830.7 billion, USD174.2 billion, USD313.4 billion and USD3.38trillion respectively. Generally speaking, the larger the capital market is, the more funds circulate, the easier it is for a company to be listed successfully.

Historically, the China A share stock market was used to be the first choice for Chinese private companies seeking listing status. However, the recent adverse factors, such as long waiting periods, rigid regulation of seasoned issues and lack of credit of the market, have compelled more and higher quality private companies to look outside China.

Pros and cons of the three markets

Table 2 Comparison among three markets

	Hong Kong stock market	Singapore Stock Market	NASDAQ
Pros	1. Medium listing cost (10%-20% of total IPO) 2. Major financial centre, liquid market, IPO and seasoned issue can be easily placed 3. Close to the Mainland, many financial institutions cover China companies 4. Institutional investors from the Mainland enter this market, targeting China companies	1. Low listing cost (5%-10% of total IPO) 2. Loose listing rules and less rigid surveillance 3. High-tech and SMEs are welcome in this market	1. Looser listing requirements than Hong Kong market 2. High reputation for companies listed in this market 3. Suitable for high-tech and IT companies
Cons	1. Complicated listing rules are and rigid surveillance 2. More and more strict censor procedure 3. Scepticism of investors and regulator towards Chinese private companies	1. Investors not familiar with Chinese companies 2. Small market, not very active	1. Very high listing cost 2. Lack of institutional investors covering Chinese companies, low liquidity for Chinese companies 3. Difficult refinancing for Chinese companies 4. Less accessible for Chinese investors

Following the analysis in Table 2, it seems that for a private company with certain scale and good performance, the Hong Kong stock market is the most favourable. Although the listing cost is higher and the regulation is more rigid, for well organized companies, listing in this rigid market may represent a high degree of quality and therefore, the development of the companies may further be facilitated. The high liquidity and comparatively simple procedure for seasoned issues can also benefit shareholders, while when listing in foreign stock markets, the companies are generally undervalued due to the unfamiliarity with the Chinese companies.

Back to the case of Wumart, the company management hoped to capitalize on the fast growing Chinese economy by broadening its retail operations, as the company's rivals were also expanding quickly. Due to the longer waiting period on the China A share market, Wumart stores chose to go public on a foreign stock market. Hong Kong's ties with the Mainland have become increasingly close. As a retail company, listing in Hong Kong stock market would improve the company's reputation, and attract more customers and potentials business partners. In fact, it is a comprehensive consideration for Wumart to choose the Hong Kong stock market.

GEM OR MAINBOARD

There are two boards in the Hong Kong stock market: the Mainboard and GEM. Below is the outline of the differences between the two boards in light of a private company's decision for listing.

Consideration 1: Location of incorporation

Both boards accept companies incorporated under the law systems of Hong Kong, Bermuda, the Cayman Islands and China PRC. For private enterprises, they can choose to be incorporated in China PRC and listed as H shares or choose to be incorporated outside of China PRC and listed as Red Chips. This will not affect which board they are aimed at.

Consideration 2: Profits requirements

The Mainboard requires that profits in the three years preceding the IPO should exceed HKD 50 million. The last year's profit should amount to more than 20 million HK$, and the first two years' profit should amount to more than 30 million HK$. For the GEM, because the high-growth enterprises may not generate profit in the initial phase, there is no profit requirement. Nevertheless, the enterprises must demonstrate that they have businesses of both substance and potential.

<u>Consideration 3: Operating history</u>

Listing on the Mainboard requires company having at least three years' business records with continuous management. The GEM requires at least two years' active business records with continuous management and shareholders. However, in GEM, the Exchange may accept a shorter period of active business than two years. The reasons acceptable to the Exchange in the following cases: (1) in respect of newly-formed "project" companies (for example a company formed for the purposes of a major infrastructure project); (2) in respect of natural resource exploitation companies; and (3) in exceptional circumstances under which the Exchange considers it desirable to accept a shorter period.

<u>Consideration 4: Main business</u>

There is no special regulation in the Mainboard, while for the GEM, the company should have an active main business. Specifically, the company should be actively engaged in one focused line of business rather than two or more disparate businesses. The reason for this is that the Exchange expects an applicant's management to be devoting its attention towards advancing one core business rather than a variety of concerns which compete or may compete for their attention. However, businesses regarded as peripheral in nature are also acceptable.

Consideration 5: Sponsorship period after IPO

On the Mainboard, if the company has listed H Shares, the company should hire a sponsor as advisor one year after IPO, while if the company is listed as a Red Chip, there is no such requirement. On the GEM, the company should hire a sponsor as advisor during the fiscal year of the IPO and for the following two complete fiscal years.

Consideration 6: Moratorium period

Mainboard has prohibited the controlling shareholders from selling shares within the first 6 months after the IPO, and should maintain their controlling status for another 6 months. On the GEM, management shareholders cannot sell their shares within 1 year after the IPO, while shareholders with holdings of less than 1% are allowed to sell their shares after 6 months following the IPO.

Consideration 7: Market Capitalization

On the Mainboard, the company must have a market value of more than HKD 200 million at the time of IPO, while on the GEM, there is no specific regulation; however, a minimum of HKD 46 million is expected to be maintained due to the public interest. This is mainly because at the time listing, if the market capitalization of the company is not exceeding HKD 100 million, the minimum prescribed percentage of securities to be in public hands must be over 20%, which is amounted to be more than HKD 30 million.

Consideration 8: Public float

For the Mainboard, the minimum public float is 50 million HK$ or 25% of shares outstanding, whichever is higher. If the market value is higher than HKD 4 billion, the proportion may be lowered to 10%. In the case of GEM, if the company's market value is less than 4 billion HK dollars at the time of the IPO, then the public float should amount to at least 25% of shares outstanding and to no less than HKD 30 million. If the market value of the company exceeds HKD 4 billion at the time of the IPO, the public float can be adjusted at 20% or HKD 1 billion, whichever is larger.

Consideration 9: Shareholders Requirements

For Management shareholders' and significant shareholders, in the Mainboard, there is no specific regulation on minimum holding shares. While for the GEM the total shares held by management shareholders and significant shareholders should be no less than 35% of shares outstanding. For the number of shareholders, Mainboardthe company should have at least 300 shareholders at the time of the IPO, and also every 1 million HK$ shares should be held by no less than 3 shareholders on the Mainboard, while on the GEM, the company should have at least 100 shareholders at the time of IPO.

In our case, Wumart had to choose GEM, because it had operating losses in the year of 2000. Thus, its profit of three years' operation is less than 50 million HK$, which conflicted with the listing rules of the Mainboard.

H SHARE OR RED CHIP OR ELSE

After we have discussed which market or board to list on for the private companies, we like to draw the attention to the selection between two branches, Red Chips and H Shares. Companies listed as H Shares are incorporated in Mainland China, in which the main operation is based in Mainland China. Contrarily, Companies listed as Red Chips are incorporated outside Mainland China and the applicable jurisdiction is different from that of China PRC. However, the company should be controlled by the Chinese parties from the Mainland, with a share of over 30%.The main business of Red Chips companies can be located in the Mainland, Hong Kong or overseas. Below are the generalized considerations affecting which branch a company will list in.

Firstly, when the company is listed as a Red Chip, all its shares can be traded in the stock market. In contrast, only part of the shares of a company listed as an H Share can be traded. Secondly, an H Share company can issue A shares in Mainland China, while a Red Chip cannot do so. Thirdly, it is very difficult for an H Share company to issue options as an incentive for employees. However a Red Chips company has no such difficulties. Fourthly, the share of the H Share companyheld by management shareholders cannot be traded or circulated without approval from the regulator. As a result, the value of this part of shares will be lower comparing to the shares in circulation. Red Chips are excluded from this restriction.. Fifthly, seasoned issues are restricted for H Share companies and can occur only once each year, while

Red Chips companies have no such limitations. Sixthly, to be listed, an H Share company has to gain approval from both the China Securities Regulatory Commission (SRC) and the HK Securities and Futures Commission (SFC). The process generally takes longer than that of the Red Chips company. Companies pursuing listing status as Red Chips do not need approval by the China SRC. According to the China SRC, companies seeking to be listed as H Shares should satisfy the following terms, in which companies seeking listing status as Red Chips do not need to comply with

1) The net assets are no less than 400 million RMB
2) The after tax profits in the year prior to the IPO are no less than 60 million RMB
3) Funds raised are no less than 50 million US$

Interestingly, Wumart Stores pursued an H Share listing status. The main consideration was likely the risk of acquisition. Wumart store is a high quality company presumably with a promising future. However, its net equity is rather low. This kind of company is typically a good acquisition target.

BASIC LISTING PROCEDURE

Step 1: Initial preparation of the IPO

The new issuer will hire a financial advisor to prepare for IPO. The preparation includes a feasibility study and the provision of relevant supporting documents. .In the course of its due diligence, the financial advisor will ensure the completion of a detailed questionnaire. The issuer will provide answers to the questionnaire and discuss with the financial advisor on issues concerned. Both parties will collaborate to conclude whether the issuer is suitable for the public listing and, if possible, will make an initial listing plan. This plan will cover the location of listing, the time of the public offer, the business to be listed, potential problems and the solutions. To facilitate the whole listing process, the issuer will appoint one top manager to take charge of the listing. Lastly, the issuer should provide all the crucial legal and business documents since the date of the company's establishment.

Step 2: Selection of professional advisors

The company will consider the following three aspects in its selection process. The first concern is the brand image of the candidates. If the financial consulting company is well-established and widely recognized by investors, it will have a higher chance to get the bid. The second concern is the professional experience of the advisor. It will be advantageous if the advisor has already advised comparable companies in the same industry to successfully float in Hong Kong. Finally, according to our interviewee, effective teamwork will be critical to the float, since the involved parties need to cooperate very closely.

Step 3: Preparation of application documents

According to the listing rules, the issuer should provide historical financial statements, forecasts, taxation documents and the valuation of assets. All these financial data should be audited and included in the prospectus. In addition, information such as the profiles of the management team, the structure of corporate governance, and the articles of association are also the important elements of the prospectus. Furthermore, the future business plan, especially the usage of the capital raised should be clearly declared. When the professional advisors prepare the prospectus, they have to demonstrate due diligence for the benefit of the investors.

Step 4: Submission of application materials

Once all the documentation[1] is completed, the application has to be submitted to the Hong Kong stock Exchange (HKEX). The HKEX will arrange a hearing[2] to evaluate the application. If the application is approved, dates will then be set for listing.

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[1] GEM Listing Rules - Equity Securities (Chapter 12) on requirement of documents submitted to Hong Kong Stock Exchange

[2] GEM Listing Rules - Equity Securities (Chapter 12) on provisional hearing date.

Step 5: Pricing of the offer

It is often critical that analysts and underwriters understand the likely demand for the shares for price setting. The pricing and placement are usually managed by the sponsor, who will recommend an offer price to the market. The company's performance to date is the key determinant for setting the offer price. Comparative analysis of other companies in similar sectors is also a useful and common tool. Analysts will look at the likely market capitalisation, price/earnings ratio and other such criteria during the price-setting phase.

Step 6: Promotion to global financial market

This is a pivotal phase - it is where the ownership entitlements to the company are offered to the market. Frequent marketing will occur at the same time as pricing. However, it is important for potential investors to gain some idea of the potential price of the shares before commitment. Therefore, pricing will generally have occurred before mainstream marketing of the offer is undertaken.

Once the HKEX has approved the registration statement and a preliminary prospectus has been distributed to interested investors, the investment bankers will start to organize road shows. These road shows serve two purposes. First, they generate interest among potential investors and provide information about the offering. Second, they provide information to the issuing firm and its underwriters about the price at which they will be able to market the securities. These indications of interest are called a book and the process of polling potential investors is called book building.

It is important that the executive management of the company is at the frontline of the marketing activities. The executive management should be responsible for selling the company story in a powerful and compelling way. Convincing investors – particularly institutional – to buy the shares will assist in a successful float.

Step 7: Listing in Hong Kong Stock Exchange

At this final stage, the company has to ensure that the listing date is communicated to the market through press releases or other forms of public announcement. Generally, the IPO reflects a combined offer form, which 25% of the shares are offered to public investors in Hong Kong and the rest is placed to overseas investors, such as international institutional investors.

If the subscription rate is desirably high, the main underwriter and the issuer may use the "claw-back" and "over-allotment option" to ensure that a sufficient number of shares is allocated to investors, especially to local investors. These adjustment mechanisms should be consistent with the regulation rules of SFC. A company stock ticker code is then created to identify the stock on all stock trading boards and electronic screens.

CONSIDERATIONS OF RESTRUCTURING

Restructuring is one pivotal phase for preparing the IPO because the offering will affect not only ownership structure and business, but also assets and human resources. The goal of restructuring is to form a solid platform for the future development of the company. First of all, restructuring should be guided by the laws and rules of both China and Hong Kong. Secondly, not only the core business of the company has to be competitive in the market at this point in time, but it needs to offer an attractive growth story for the next 3 to 5 years. The funds raised in the pre-IPO and IPO phases could support the business development plan of the company. In addition, the issuer should meaningfully organize the relationships with the listing company, the parent companies and the related companies and try to reduce the related transactions as much as possible. Specifically, the parent company should not compete with the listing company in the same industry. Furthermore, the issuer should continuously improve corporate governance and employee productivity, in order to maximize the value of the shareholders' ultimately.

There are lots of considerations during restructuring. The immediate one is taxation. The problem is to decide whether the parent company or the listed company bear the listing cost. The dilution of stake, as well as ownership structure, should also be thought over to estimate the effect on future business operations. The direct purpose of restructuring is to improve the listed company's competitiveness in the industry. Thus the non-core and/or peripheral business lines, according to our interviewee, should be separated from the issuer. The issuer should also evaluate the situation of related transactions after restructuring. If related transactions decrease, the restructuring will tend to be more acceptable. Furthermore, the issuer will estimate the effect of restructuring on the historical financial data and report to the HKEX. Finally, the issuer and its professional advisors will, according to the company's practical needs, choose one or more of the following re-structuring methods: separation of non-performance assets, exchange for high qualified assets, and re-arrangement of liabilities.

The main reorganization activity Wumart Stores has performed was to convert the company from a limited liability company into a joint stock limited company. This reorganization served as a listing preparation.

ROLE OF FINANCIAL ADVISORS

Generally speaking, the advisor will co-ordinate and control the whole IPO process. One of the task is to suggest how to restructure the existing business lines to make future business plans more appealing to investors. The advisor will also give advice in issues related to listing rules, such as related transactions and competition with the parent company, and recommend the best way and place of listing and assist in preparing the prospectus and other documents for IPO application. Besides, the advisor will coordinate and help the company to get necessary approval as well as exemption from the regulation departments of the SFC and the HKEX. Last but not the least, strategic investors will also be introduced to the company.

For the responsibilities of sponsors, they will conduct the feasibility study of listing by carrying out due diligence in the early stage to assess the qualification of the company for an IPO. Skills and experiences of the top management will then be evaluated and the obligations as executives of a listed company to the management team will be fully explained. This process can assist them in deciding whether to go public or not. In the IPO stage, they act as the main communication channel between the HKEX and the listing company. Moreover, they cooperate with other professional advisors such as accountants and lawyers to prepare the application documentation. Additionally, sponsors are required to sign on the application and guarantee forms.

CHAPTER 3: DATA AND METHODOLOGY

RESEARCH PERIOD AND SOURCE

We examine the companies which go IPO in Hong Kong from 1994 to 2004. All these companies are in the retail sector. We conduct the interviews with the investment bankers who have the first-hand experience on pricing the equities during IPO.

Information of the company name, listing date, offering price, is collected from the prospectus, Reuters, and the website of Hong Kong Exchange. The figure of funds raised by each IPO is obtained from Hong Kong Exchange's Fact Book 1994-2004. The closing prices of the IPO firms are extracted from the on-line database DATASTREAM. Also, the Hang Seng Index in the corresponding day is extracted from DATASTREAM as well.

MEASURES AND FORMULAS

We give measures of underpricing and post-IPO performance in Chapter 4 and Chapter 5 respectively.

CHAPTER 4: UNDERPRICING ANALYSIS

LITERATURE REVIEW

Initial public offering (IPO) underpricing, or high IPO initial return, is a phenomenon common to most stock markets - both in developed and emerging economies. A common perception is that underpricing of IPOs is a contradiction to market efficiency and may hurt emerging firms trying to raise capital for expansion. Therefore it has spawned an extensive literature attempting to explain this apparent financial anomaly. A number of theories of IPO underpricing have been put forth and tested against the data of various stock markets. We would like to list three well known models in the followings.

Rock's (1986) model

Two classes of IPO investors are assumed to exist, informed and uninformed. Informed investors, having learned the true firm value through costly information search activities, will only subscribe to issues that they know to be underpriced, whereas uninformed investors will subscribe to all issues. As a result, the uninformed investors face a winner's curse, in that their expected return, conditional upon being allocated shares, is less than their expected return, conditional upon submitting a purchase order. In order to secure the uninformed investors' participation in the market for IPOs, issuers must then underprice their shares to ensure that the uninformed investors' expected return conditional upon being allocated shares is non-negative.

Ex-ante uncertainty model

Beatty and Ritter (1986) argues that underpricing increases with uncertainty. The model includes a price setting mechanism for both the primary and secondary markets. The secondary price is a function of all private information, and may not equal the true asset value. The payoff to investors participating in the IPO is determined by an uncertain initial market price, not the true value. Selling the shares in the primary market represents a transfer of risk to investors. By acquiring this risk investors insure the issuer against an adverse market reception to the offering. The premium for this insurance is the intentional underpricing. The issuer will generate information in the primary market that increases the precision of the estimate for the initial market price, reducing the necessary underpricing.

Signaling model

In the IPO underpricing literature, Allen and Faulhaber [1989], Grinblatt and Hwang [1989], Welch [1989] and Chemmanur [1993] point out that IPO underpricing may serve as a signaling device. By underpricing their shares in the IPO, good firms can signal their type. Then, the original owners of good firms may benefit from higher share prices when they sell their remaining equity in the secondary securities market (Allen and Faulhaber [1989], Grinblatt and Hwang [1989]), or when they arrange future seasoned offerings (Welch [1989]). Furthermore, good firms may benefit from future analyst coverage (Chemmanur [1993]).

MEASURING UNDERPRICING

Underpricing is typically determined with reference to the initial return an investor receives, given a full allocation of shares. This return is measured by assuming investors sell their allocation on the first date of listing. The convention in most studies is to compare the closing pricing of the stock on its first day of listing with the offer price. We also use this form to measure initial return of retail industry of Hong Kong market.

$IR_i = 100\% * (P_{i,1} - P_{i,0}) / P_{i,0}$

Average $IR = \sum IR_i / N$

Where:

IR_i = initial return for company i

$P_{i,1}$ = the closing price on the first day of trading for company i

$P_{i,0}$ = the IPO offer price for company i

N = the number of companies

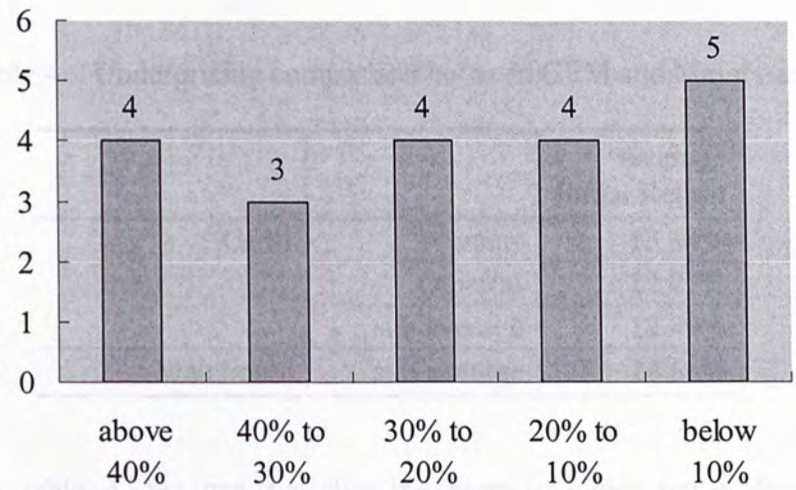
RESULTS AND DISCUSSIONS

We calculate the initial return of 20 listed companies in retail industry. We find that underpricing is a general phenomenon since none of these companies gives negative initial return to investors, which means that in any IPO subscription of these companies, investors won't lose money on the first day. This conclusion is consistent with the underpricing in other countries and regions. Here we ignore the transaction cost which is necessary in reality. In table 3 and figure 1, we examine the frequency distribution of rate of return.

Table 3 Frequency Distribution of initial return

Range of % rate of initial return	Frequency
above 40%	4
40% to 30%	3
30% to 20%	4
20% to 10%	4
below 10%	5
Total	20

Figure 1: Frequencey Distibution



As illustrated in table 3 and figure 1, the initial returns in retail industry are also evenly distributed in the ranges given. However, the initial returns of these retail companies vary from each other as the characteristics of their IPOs are quite different. Some companies have listed in Mainboard but some others in GEM since they may not fulfill the requirement of Mainboard listing rules. Some companies are from the Mainland and list in Hong Kong while other companies are local Hong Kong enterprises. It is widely know that Hong Kong is seriously affected duringthe Asian Financial Crisis in 1998 and therefore, we want to explore the difference of the initial returns for companies listed both before 1998 and after 1998. Moreover, the amount funds raised is also important to the extent of underpricing.

Underpricing from GEM/Mainboard perspective

Table 4 Underpricing comparison between GEM and Mainboard

		Average Initial Return
GEM	Wumart	13.34%
	Other(s)	12.27%
	sub average	12.49%
Mainboard	sub average	28.66%

From table 4, we can see that the average initial return for mainboard companies is more than twice as that for GEM companies. The phenomenon is understandable as companies face stricter regulation requirements to list in Mainboard compared to list in GEM, which will make investors more confident in the financial performance and corporate governance for these Mainboard companies. In GEM category, the initial return of Wumart is a bit higher than the figure of others. This may be due to its larger market capitalization[3].

Underpricing from H/non-H share perspective

Table 5 Underpricing comparison between H share and non-H share

		Average Initial Return
H share	Wumart	13.34%
	Other(s)	9.68%
	sub average	11.51%
Non-H share	sub average	26.07%

[3] See Appendix 1 for details.

From table 5, we can see that the average initial return for non-H share companies is more than twice as that for H share companies. We also notice that all these non-H shares are Hong Kong local companies. Information availability is one of the most important considerations for investment. Generally speaking, investors will bear more risk if they choose to invest in H share companies because of lacking necessary information of the Mainland market and government policy. In H share category, the initial return of Wumart is higher than the figure of the other company, Lianhua. In the Mainland, both of them are large players in retail industry. However, Wumart is a private company while Lianhua is a typical state-owned enterprise. So the different extents of underpring demonstrate that private Mainland companies are more appealing to investors.

Underpricing from listing time perspective

Table 6 Underpricing from listing time perspective

		Average Initial Return
After 1998	Wumart	13.34%
	Other(s)	14.83%
	sub average	14.72%
Before 1998	sub average	43.00%

According to table 6, the average initial return for the companies listed before 1998 is significantly higher than that for those listed after 1998.. The confidence of Hong Kong investors were seriously destroyed especially in years just after the Asian Crisis and they did not show much enthusiasm to subscribe the unseasoned offerings. From another aspect, this also demonstrates the Hong Kong stock market is much more mature after 1998, which would favor long-term healthy development. The initial return of Wumart is a bit lower than the average figure which may be caused by the listing in GEM rather than Mainboard.

Underpricing from funds raised perspective

Table 7 Underpricing from funds raised perspective

(HKD)		Average Initial Return
Above 100 million	Wumart	13.34%
	Others	30.36%
	sub average	28.23%
Below 100 million	sub average	22.20%

The above table 7 shows that the average initial return for the companies with funds raised above 100 million HKD is quite higher than for those with funds raised below 100 million. The initial return of Wumart is significantly lower than the figure of peers in same category – above 100 million. Partly because some companies in this category went IPO before 1998 which means the market atmosphere is quite favorable. In addition, other companies in this category with higher initial return are local companies which maybe better choice for local investors.

CONCLUSION

Through empirical research of the companies in retail sector of Hong Kong stock market, most companies in this sector are underpriced in IPO, which is consistent with the current conclusion of this topic. Generally, subscription of IPOs of Mainboard, non-H share, higher funds raised will bring investors more return especially before 1998. Particularly, investors like to appreciate private Mainland companies more than State Owned Enterprises.

CHAPTER 5: POST-IPO PERFORMANCE ANALYSIS

LITERATURE REVIEW

In Post- IPO performance area, many outstanding economists have contributed a lot. Some of the predominant papers are reviewed below:

Jay.R.Ritter (1991)

Ritter researched on 1526 IPOs between 1975 and 1984, obtained the three year return of 34.47%, while a sample of 1526 firms with the consistent industry and size had the return of 61.86%. Ritter therefore drew a conclusion that: '(1) investors are periodically overoptimistic about the earnings potential of young growth companies, and (2) firms take advantage of these "windows of opportunity".'

Tom Loughran & Jay. R. Ritter (1995)

The authors found that companies issuing during 1970-1990 had poor performance in a long run. Companies going public had only average 5% return every year during five year period after IPO, while the number for companies doing seasoned issued was only 7%

Alon Brav & Paul A Gompers (1997)

Brave and Gompers did research on a sample of 934 venture-backed IPOs and 3407 nonventure-backed IPOs and found that underperformance was not due to IPO. Similar size and book to market firms which did not issue equity had the same poor performance as IPOs.

Bharat A. Jain & Omesh Kini (1994)

Bharat A. Jain and Omesh Kini also found the poor Post-IPO performance. They also found that there was a positive relation between Post-IPO performance and equity retention by the original entrepreneurs while there was no relationship between Post-IPO operating performance and the level of initial underpricing.

Now we conduct Post-IPO performance research based on weekly return basis. Since some companies in the data sample were brought public after 1997, this paper covers comparatively short time window of 12 months only.

MEASURING POST-IPO PERFORMANCE

If a company i's closing prices on a given trading Monday[4] t within a five-day trading week is Pi,t a weekly return is defined as the simple net return on stock i between two subsequent Mondays:

(1) $r_{i,t} = (P_{i,t} - P_{i,t-5})/P_{i,t-5}$

(2) $AR_{i,t} = r_{i,t} - rBM_{,t}$

(3) $CAR_{i,T} = \sum_{t=1}^{T} AR_{i,t}$

(4) $CAR_T = (1/N)*(\sum_{i=1}^{N} CAR_{i,T})$

where

$r_{i,t}$ the return[5] on stock i between two subsequent Mondays

$P_{i,t}$ the company i's closing prices on a given trading Monday t

$P_{i,t-5}$ the company i's closing prices on a given trading Monday t-5

$AR_{i,t}$ a benchmark-adjusted return for a given stock i in event week t

$rBM_{,t}$ the benchmark's return $rBM_{,t}$ in week from t-5 to t

$CAR_{i,T}$ cumulative abnormal return for company i over T trading weeks

CAR_T average cumulative abnormal return for N companies over T trading weeks

Our data sample is composed of 20 listed companies including Wumart in the retail industry. The average cumulative abnormal return for these composite is

[4] If a holiday falls on a Monday, we use the next trading day instead.

[5] When we calculate the return in this article, we don't consider the transaction cost for simplicity.

negative, which is complied with the fact that some economists had also found. To be more specific, we do some deep diggings from four perspectives.

RESULTS AND DISCUSSIONS

We will compare post-IPO performance from three perspectives: GEM/Mainboard, H/non-H share, and the time point of 1998. Moreover, we will establish a linear regression model to analyze the relationship between underpricing and Post-IPO performance.

Post-IPO performance from GEM/Mainboard perspective

Table 8: Post-IPO performance comparison between GEM and Mainboard

		Cumulative Abnormal Return
GEM	Wumart	60.71%
	Others	-11.70%
	sub average	3.48%
Mainboard	sub average	-5.91%

The result turns out that the after-IPO performance of GEM companies outperforms than that of Mainboard. The possible reason is some high quality companies in GEM generally have intention to transfer from GEM to Mainboard. To fulfill this goal, the management should improve the company's operating performance and promote the company's image.

<u>Underpricing from H/non-H share perspective</u>

Table 9: Post-IPO performance comparison between H share and non-H share

		Cumulative Abnormal Return
H Shares	Wumart	60.71%
	Others	45.01%
	sub average	52. 86%
Non-H Shares	sub average	-10.02%

From the table 9, we can find that companies from the Mainland have a higher average CAR in one year period than that of Hong Kong companies. The possible reason behind this phenomenon could be investors are not as familiar with Mainland companies as with Hong Kong companies. Thus, at the initial phrase, Mainland companies are undervalued. This undervaluation might be released gradually later.

In the following, we will differentiate the companies by time point. In 1998, Asian Finance Crisis impacted Hong Kong capital market, and the stock market of Hong Kong was suffered greatly. Thus we have separated our samples into two groups: before and after 1998.

Underpricing from listing time perspective

Table 10: Post-IPO performance from listing time perspective

		Cumulative Abnormal Return
After 1998	Wumart	60.71%
	Others	3.03%
	sub average	7.36%
Before 1998	sub average	-29.63%

The post-IPO performance of companies listed after 1998 is better than that of companies listed before 1998. The possible reason is after the crisis, investors generally hold a more prudent attitude to the new listing companies. Thus these companies are undervalued and consequently are released.

CONSTRAINTS OF RESEARCH

The first limitation of our research is the small sample size. We have just 20 companies, which may reduce the significance of the statistical tests. The other is that the time of sample space is concentrating in recent years. Due to these factors, further studies should be considered using a larger sample in terms of number of firms and longitudinally. We would like to collect more data later on for refinement of this article.

APPENDIX

1. Initial Return and Cumulative Abnormal Return of IPOs in Retail Sector

Listing Date	Stock Code	Name	GEM / Mainboard	H /Non-H Share	Funds Raised (million HK$)	Initial Return	Cumulative Abnormal Return
25/1/1994	0990	Theme INT'L	Mainboard	Non H	97.20	22.31%	8.92%
4/2/1994	0984	Aeon Store (HK)	Mainboard	Non H	104.00	43.75%	-25.26%
17/2/1994	0996	Pricerite GP.	Mainboard	Non H	69.00	73.33%	-36.14%
17/9/1996	0393	Glorious Sun Enter.	Mainboard	Non H	400.00	50.00%	15.61%
6/12/1996	1179	Mirabell INTL.HDG.	Mainboard	Non H	73.20	35.25%	-63.99%
6/5/1997	0590	Luk Fook HDG.(INTL.)	Mainboard	Non H	114.00	23.00%	-76.94%
13/6/1997	178	Sa Sa INT'L	Mainboard	Non H	897.74	53.36%	-22.47%
13/4/2000	686	GAY GIANO	Mainboard	Non H	60.00	15.83%	8.49%
11/2/2002	130	Moiselle INT'L	Mainboard	Non H	70.00	26.00%	-42.23%
11/3/2002	1161	Water Oasis GP	Mainboard	Non H	88.13	10.19%	-36.85%
10/5/2002	915	Linmark Group	Mainboard	Non H	301.39	32.14%	11.51%
7/11/2002	221	LeRoi Holdings	Mainboard	Non H	50.60	20.00%	2.38%
27/6/2003	980	Lianhua	Mainboard	H	668.44	9.68%	45.01%
16/7/2003	653	Bonjour HOLD	Mainboard	Non H	59.08	14.44%	93.25%
15/4/2004	1212	Lifestyle INT'L	Mainboard	Non H	1718.10	0.60%	30.09%
11/12/2001	8020	Wanasports	GEM	Non H	28.05	9.09%	-78.08%
21/5/2002	8136	FX Creations	GEM	Non H	21.06	0.00%	65.29%
17/6/2002	8126	G.A. Holdings	GEM	Non H	50.00	40.00%	-18.07%
27/6/2003	8272	Byford INT'L	GEM	Non H	30.12	0.00%	-15.95%
21/11/2003	8277	Wumart	GEM	H	547.06	13.34%	60.71%

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