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Investment bank reputation and relaxed listing requirements: Evidence from infrastructure firm IPOs in Hong Kong

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Abstract

In early 1996, the Stock Exchange of Hong Kong allowed firms focusing on infrastructure projects to issue initial public offerings (IPOs) under a relaxed set of listing requirements, allowing these firms to go public with a shorter history or lower profitability levels. We provide evidence that these firms are no more speculative than firms listing under the regular requirements. To the contrary, we find that firms listed under the relaxed requirements are taken public by reputable investment banks and that these firms have characteristics that otherwise mitigate their lack of earnings history. These patterns are consistent with investment banks avoiding highly speculative issues to protect their reputations. © 2001 Elsevier Science B.V. All rights reserved.

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1. Motivation

The need for funds to develop infrastructure in emerging markets is huge and growing. For example, the World Bank estimates that Latin America and the Caribbean currently need to invest 4.5% of GDP each year on power, transport,

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telecoms, sewage, and water supply upgrades.¹ These funding requirements are far beyond what multilateral agencies and federal governments can provide. Therefore, emerging market countries have had to turn to private sources to help finance these projects.

To date, private equity funds have been the primary vehicle for infrastructure investments. Market participants, though, argue that public funds, via stock market listings, are needed to both expand the pool of available money and to provide an exit strategy for the initial private investors. Several countries, recognizing the need for public funds and the short lives of most infrastructure firms, have developed relaxed listing requirements for infrastructure firm initial public offerings (IPOs). Hong Kong, Malaysia, and Singapore, for example, all announced plans to establish relaxed listing requirements for infrastructure firms in late 1995.²

By relaxing the requirements on trading record period and profit levels, Hong Kong's relaxed listing requirements, called sub-rule 8.05(2), allow infrastructure project companies to list on the Stock Exchange of Hong Kong (SEHK) at an earlier stage of their lives. Before the stock exchange implemented the relaxed rules, all firms had to meet the basic, or regular, listing criteria. Among these rules, the SEHK requires that, "A new applicant must normally have a trading record of not less than 3 years under substantially the same management. The profit attributable to shareholders must, for the most recent year, be not less than HK\$20 million and, for the 2 preceding years, be in aggregate not less than HK\$30 million."³ Under the relaxed rules for infrastructure project companies, firms are allowed to issue an IPO even if they have fewer than 3 years of audited financial statements and/or lower profit levels than the formal thresholds.

Since implementation of the special rules for infrastructure project companies, infrastructure firms can choose whether to issue stock on the exchange early in their lives by listing under the relaxed requirements, or, alternatively, to wait until they are more seasoned and list under the regular requirements. One might ask how investors react to stock issues by firms under the relaxed rules. Are the relaxed listing firms considered more risky or speculative than comparable regular listing firms? Or, do the investment banks, concerned about their reputations, only sponsor those firms that somehow compensate for the lack of a comparable earnings history?

This paper provides evidence on Hong Kong's experience to date with relaxed listing requirements for infrastructure firm IPOs. We study infrastructure listings

¹ *Economist*, "Privacy please: Infrastructure in Latin America" (July 27, 1996) 54–55.

² In the late 1990s, listing requirements in several exchanges were also lowered for internet firms (for example, Mothers in Japan).

³ "Trading record" refers to years of operation. This quote is from the SEHK website, www.sehk.com.hk. Throughout the 1990s, the Hong Kong dollar was pegged at HK\$7.8 per \$US1.

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