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## What explains the initial return of initial public offerings after the 1997 Asian financial crisis? Evidence from Thailand



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### ABSTRACT

Do financial development, domestic interest rates, and interest-rate differentials simultaneously affect the underpricing of initial public offerings (IPOs) in emerging market countries? Using a sample of 187 IPOs in Thailand between 2000 and 2012, I show that financial development, stock market conditions, bond market development, and interest-rate differentials affect the initial return, and that several of these effects appear to be contingent on (1) whether the IPOs are hot or cold and (2) whether the interest-rate differential is positive or not. During periods of positive interest-rate differentials, the effect of the interest-rate differential on the initial return is positive and economically significant. Overall, my findings suggest that investors might undertake carry-trade strategies in the IPO market. In addition, the initial return of the IPOs in my sample appears to be lower than the initial returns reported by previous studies using the pre-1997 financial crisis period sample.

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## 1. Introduction

Following the 1997 Asian financial crisis, major financial and regulatory reforms in Thailand (as well as in other crisis-hit countries, such as Indonesia and South Korea) have been undertaken under

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the guidance of the International Monetary Fund. These reforms should have led to (1) lower levels of informational asymmetries in capital markets and (2) higher levels of transparency in financial markets. In addition, domestic (and, in particular, retail) investors in Thailand have become more knowledgeable and sophisticated after the crisis as less sophisticated (and/or uninformed) domestic investors were largely driven out of the markets by the crisis. Given these characteristics, the initial public offering (IPO) market in Thailand<sup>1</sup> is an interesting context not only to indirectly test whether the level of information asymmetry<sup>2</sup> affects the level of the IPO underpricing but also to test whether financial development is associated with the IPO underpricing. The IPO underpricing is a situation in which the first-day market closing price of IPOs is higher than its corresponding offer price.

If asymmetric information accounts for the level of IPO underpricing, we will naturally observe declining levels of IPO underpricing in emerging countries when their economy substantially develops and the levels of asymmetric information decrease. Thus, according to the information asymmetry hypothesis, there should be a negative relation between financial development and the initial return of the IPOs. However, financial development should attract larger amounts of foreign investment in the stock market, suggesting that the relation between financial development and the initial return should be positive. Thus, two competing hypotheses offer a different predicted sign of the impact of financial development on the initial return of the IPOs. However, as Ritter (1991) argues that the levels of optimism about the economy amongst investors is likely to play a strong role in explaining the short-run stock return of the IPO than the levels of asymmetric information, it is possible that the positive effect of financial development might outweigh the negative impact.

Consistent with the financial development literature, I argue that financial development positively affects the initial return of the IPO. As foreign investors are more likely to be selective in choosing countries in which they invest, the level of financial development might signal whether equity and bond markets are large enough to attract foreign investors. As the participation of foreign investors in the IPO market increases, all else equal, the initial return is expected to be higher due to an outward shift in the demand curve for the IPOs. Rising interest-rate differentials should lead to higher initial returns as a demand curve for the IPOs is shifted outwards due to carry-trade activities in the IPO markets. As several researchers (e.g., Baillie, 2011; Hochradl and Wagner, 2010; Moore and Roche, 2012; Sarno et al., 2012) show the existence of a forward bias in currency markets, there is a question of whether carry-trade strategies are also carried out in the IPO market in the emerging market countries. In a recent study, Coudert and Mignon (2013) note that with respect to carry-trade gains, the Thai baht (THB) is one of the most rewarding currencies, according to the Sharpe ratios. If interest-rate differentials are positive, it might be worthwhile to invest in IPOs by borrowing low-yield currencies (e.g., the US dollar and the Japanese yen) when high-yield currencies (e.g., the THB) are not expected to depreciate.<sup>3</sup> Thus, the IPOs in high-yield currencies may attract carry-trade positions in the IPO market, suggesting the positive effect of the interest-rate differential on the initial return of the IPOs.

In this paper I focus on previously unexamined dimensions of interest-rate differentials in determining the initial return of the IPOs: the interplay among the development of financial markets, the domestic interest rates, and the interest-rate differentials. The effects of the first two on the initial return of the IPOs have been examined in the literature, but the effects of the three can occur simultaneously but have yet to be studied. I argue that during periods of stock market booms, falling domestic interest rates, and rising interest-rate differentials, the initial returns on the IPOs can be large. The potential magnitude of the spike in the initial return on the IPOs created due to the interest-rate differential effect is better illustrated through a hypothetical scenario in which domestic investors decide to participate in the IPO market at a lower level of involvement (e.g., assigning a smaller-than-normal weight to the IPOs in their portfolio) due to high interest rates. Suppose that the demand in the bond market is weak, thereby resulting in higher yields on both government and corporate bonds, so that some domestic investors allocate a higher weight to relatively cheap bonds (i.e. with higher yields). In

<sup>1</sup> IPOs in Thailand generally follow the bookbuilding mechanisms as those used in the US.

<sup>2</sup> One of explanations for the IPO underpricing is concerned with the level of information asymmetry (e.g., Rock, 1986).

<sup>3</sup> This strategy is, however, riskier than typical carry-trade strategies in fixed-income securities that take a long position in high-yield bonds in one currency (e.g., the Brazilian real) and a short position in low-yield-bonds in another currency (e.g., the Japanese yen).

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