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Hong Kong's Fickle IPO Investors

By PRUDENCE HO

In the midst of the most choppy markets since the global financial crisis, companies seeking to list in Hong Kong have to deal with one more unpredictable factor: the retail investor.

In May, Milan Station Holdings Ltd., a small Hong Kong company that sells second-hand luxury handbags, captured investors' imagination—and money—with a US$40 million initial public offering whose retail portion was a record 2,179 times oversubscribed. The stock soared 66% on its debut, although it has given up nearly half of those gains since then.

But only a few weeks later, retail investors didn't take up all the shares made available to them in the US$2.47 billion IPO of luxury group Prada SpA, despite heavy promotional efforts that included a glitzy fashion show for the city's elite. Shares barely rose on their debut but have since risen steadily and closed Monday up 13% from the HK$39.50 IPO price.

Mom-and-pop investors are helping to make or break an IPO's reputation as "hot" in Hong Kong, one of the busiest markets for new listings in the last few years and one that is increasingly attracting companies from outside the city and China.

But their presence isn't always welcomed by bankers, who say outsized demand and the tendency of those investors to quickly sell can make their job harder.

"Retail investors could add more volatility to the deal; the majority of institutional investors tend to hold for a longer term," said David Suen, co-head, Asia ex-Japan equity capital market of J.P. Morgan Chase & Co., one of the banks in charge of Tibet 5100 Water Resources Holdings Ltd.'s recent US$177 million Hong Kong IPO.

Part of the power of the retail investor is because local regulators, uniquely, require that 10% of every IPO be set aside for the average investor, unless the issuer applies for a waiver to reduce that amount in favor of institutional investors like mutual funds, pension funds and hedge funds.

In the U.S., by contrast, a deal could go entirely to institutional investors.

Moreover, if demand from Hong Kong retail investors exceed certain levels, a rule known as a clawback requires that they be given a greater percentage of the offering. At its most extreme, if retail subscription is 100 times or more the number of shares offered to them, they must then receive half of the offering. According to Dealogic, 29 Hong Kong IPOs in 2010 and 2011 have had so much demand that the maximum clawback was triggered.

Finally, Hong Kong investors have a reputation for being quick to flip stocks. One reason is that they often buy on margin, fronting just 10% of the value and relying on the brokerage to finance the remaining 90%. Investors who receive shares worth more than their 10% deposit may opt to sell shares to avoid stumping up more money.

As a result, bankers say they have a harder time picturing how IPOs that get heavy retail demand will do after listing.

In some recent IPOs, demand from retail investors fell short of the amount reserved for them. Some cited weak stock markets, which to some investors lessened the likelihood of a quick profit. Ironically, some say that has made it easier for banks to make sure offerings do well.

Bankers hired for an IPO do more than advise the company and sell the shares. They also are supposed to "stabilize" the share price for the first 30 days—which means keep it from falling below the IPO price if possible.

"It could be a challenge for underwriters to stabilize the share performance after listing if half of the offered shares are in the hands of retail investors, as there are a lot of day traders just looking for quick gains," said West Riggs, head of Asia equity capital markets at Piper Jaffray Asia. His firm was a key banker on 17 IPOs for China-based companies in Hong Kong and U.S. over the past 18 months.

Money managers, too, must assess how retail investors will affect the stock price, but say that doesn't drive their investment decisions.

"We focus more on the long-term competitive edge of a company rather than the short-term performance of a stock," said Joseph Zeng, managing director of Greenwoods Asset Management HK Ltd, a Greater China fund management company in Hong Kong. "We feel that sometimes retail involvement into an IPO is primarily driven by the market sentiment during the offering period, which may not always reflect the fundamental of a company."

In the case of Lhasa-based mineral water firm Tibet 5100 Water, retail investors took up only 87% of their allocation. Nonetheless, shares jumped 23% on their debut and were up 48% from the HK$3 IPO price, closing Monday at HK$4.45.

While Hong Kong's IPO rules tend to favor the retail investor, "I suspect bankers would rather be in a position to allocate a greater percentage of a deal to their institutional clients if they think a deal is going to be profitable for investors," said Chris Betts, Hong Kong-based capital markets partner at the international law firm Paul Hastings, Janofsky & Walker.

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