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CUHK Business School Research Reveals That Cornerstone Investor Agreements Bring Immense Advantages to Post-IPO Earnings Growth

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Cornerstone Investments Exhibit Positive Association With IPOs Launched on Hong Kong Stock Exchange's Main Board in Terms of Initial Value Multiples, M/B ratio, Tobin's Q Ratio, Trading Volume and Price Stabilization

HONG KONG, CHINA--(Marketwired - Nov 12, 2015) - To facilitate the completion of IPOs, more and more companies looking to list on the Hong Kong Stock Exchange (HKEx) are turning to cornerstone investors. What role do such investors play in the capital market and how do they influence a firm's IPO value? Research by Prof. Paul B. McGuinness of the Chinese University of Hong Kong (CUHK) Business School offers an in-depth look at these topics.

Cornerstone investor agreements have become increasingly common in the Hong Kong stock market in the past 10 years or more. Such agreements, which have essentially evolved through the Hong Kong marketplace, are still fairly uncommon in many other major capital markets. But in Hong Kong, regulatory and market conditions combine to encourage the inclusion of cornerstone allocations in IPOs.

Paul B. McGuinness, a professor at the Department of Finance of CUHK Business School, explains how such investments work. He notes that cornerstone investors are typically high net-worth parties, and include among their number local tycoons, Chinese state-invested entities, privately controlled public companies, sovereign investors and institutional investors like asset managers. Such parties commit with book-runners to buy a defined block of stock. This commitment is made just ahead of the formal IPO application period. However, cornerstone parties accede to post-IPO lock-ups on their earmarked allocations, during which time they cannot transfer the shares. Prof. McGuinness further notes that unlike private equity investment, cornerstone investment comes in during the IPO period itself (although the contractual obligations surrounding such agreed allocations are finalized just prior to the prospectus release). Cornerstone parties thus pay the same offer price as all other IPO subscribers. By contrast, he notes that any private equity investment occurs well ahead of IPO, sometimes months or even several years prior to listing. Private equity stakes typically occur at sizeable discounts to eventual IPO offer prices, at least in those cases where listing of the invested entity arises.

The fact that the particulars of cornerstone allocations are disclosed in the IPO issue document (prospectus) means such parties' identities are revealed before the formal application period commences. As Prof. McGuinness notes, "cornerstone investors are lending visible and high-profile support to the IPOs." At the same time, he points out the larger such allocations and the more extensive the lock-ups (typically set at a minimum of six months), the greater the potential "certification (i.e. endorsement) effect."

Why has Hong Kong's IPO market taken such a leadership role in the area of cornerstone

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investment? Prof. McGuinness believes it is due to a combination of factors: "On one hand, Hong Kong's regulatory environment is quite flexible, which allows for significant cornerstone investor presence. On the other, the emergence of cornerstone investment is closely tied to the growth and expansion of mainland Chinese enterprises as well as Hong Kong's strategic and political relationship with the mainland. International institutions, corporate parties and Asian tycoons have shown a keen interest in investing in Chinese companies listed in Hong Kong, so the demand is strong. Other markets may also have regulatory flexibility but not necessarily the demand for such allocations."

According to Prof. McGuinness, "many market watchers see cornerstone parties as value investors. The typical nature of such parties, sovereign funds, institutional investors, tycoons and high net-worth individuals, as well as the post-IPO lock-ups that they have to adhere to, suggest certain certification effects. Cornerstone presence therefore serves as a potential signaling device."

Connection with IPO Firm Value

So what is this "certification effect" in the context of an IPO? In a research paper titled "IPO firm value and its connection with cornerstone and wider signaling effects,"[1] Prof. McGuinness looks into cornerstone investors' role in signaling or certifying IPO value. He points out that certification effects have been widely examined in connection with venture capital investment, dating back to Megginson and Weiss' (1991, Journal of Finance, 46/3: 879-903) seminal study on the subject. "However, there is very little information about cornerstone investment in the academic literature. This is because such investment is not commonly found in European and American markets," he explains.

Prof. McGuinness' study focuses on IPOs launched on HKEx's Main Board between January 2005 and December 2009, a period characterized by a proliferation in cornerstone investor agreements. His study reveals several important findings. First, cornerstone presence displays strong association with initial value multiples, market-to-book (M/B) ratio and Tobin's Q ratio. Strong associations are also apparent when looking at other cornerstone dimensions: size of allocation, lock-up period and number of investing parties. Thus, greater cornerstone involvement correlates with higher M/B and Tobin's Q levels. The study also examines possible causal effects between equity value and cornerstone participation.

The study's second major finding, which reinforces the signaling angle, is that cornerstone investment exhibits positive association with post-IPO earnings growth. As a third important result, Prof. McGuinness determines that cornerstone invested-entities display more resilient and stable trading volumes during an IPO firm's first 30 days' listing. He also finds book-runners' on-market purchase (or price stabilization) activities to be less common in cornerstone-invested entities -- an outcome he ascribes to such entities' more resilient secondary market price performance during their first few weeks of listing.

Prof. McGuinness's article also investigates a range of other signaling devices and valuation effects. In particular, he finds higher valuation multiples in offerings with a smaller initial retail tranche component. His study also identifies higher Q multiples in issues with an international (as opposed to domestic) placing tranche and in IPOs containing secondary offers (i.e., vendor or controller sales).

Commenting specifically on the cornerstone effects, Prof. McGuinness opines: "Obviously, there must be significant benefits to listing companies and their controllers from the procurement of cornerstone investors. Benefits also arise for the book-runners/underwriters in terms of stimulating market demand for the IPO."

"Retail investors may be more inclined to buy a company's stock if they see cornerstone investors buying into it, especially where the cornerstone parties have a proven record of value investment," says Prof. McGuinness. "For example, if a leading Hong Kong tycoon invests, some retail investors may place greater trust in the underlying company and the pricing of the issue. Some investors may also feel that cornerstone presence adds a further layer of monitoring or due diligence, especially where cornerstone parties lock in for an appreciable period. In short, cornerstone investment can excite subscription demand."

Higher Level of Transparency

Cornerstone investment comes with detailed disclosure. "Usually, you cannot get precise disclosure of share allocations in the international placing arm of an IPO. But where cornerstone agreements exist, which form a part of the placing tranche allocation, cornerstone parties' identities, dollar amount of committed investment and lock-ups quickly become apparent," says Prof. McGuinness.

The professor notes that cornerstone investment in Hong Kong could be an attractive factor for international investors. But from a broader investor perspective things may not be so straightforward. He points out that some investors might feel that cornerstone investors, by being able to secure a large amount of shares, crowd-out smaller investors. But, as mentioned, there are positives from cornerstone allocations. One is increased transparency. As Prof. McGuinness maintains, "Cornerstone allocations enable us to know more about a key part of the international placing tranche allocation."

While acknowledging the mixed views that cornerstone agreements sometimes arouse, Prof. McGuinness concludes that such investment is now an important part of the Hong Kong IPO terrain. Moreover, cornerstone investment appears to be gaining importance in other markets, particularly in the Asia Pacific region. Study of cornerstone investment therefore offers lessons for other markets that have just embraced such investment in their IPO markets.

Reference

1. Paul B. McGuinness, "IPO firm value and its connection with cornerstone and wider signalling effects," Pacific-Basin Finance Journal, Vol. 27(2014) pp.138-162 (http://www.sciencedirect.com/science/article/pii/S0927538X14000213).

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CUHK Business School comprises two schools -- Accountancy and Hotel & Tourism Management -- and four departments -- Finance, Decision Sciences and Managerial Economics, Management, and Marketing. Established in Hong Kong in 1963, it is the first business school to offer BBA, MBA and Executive MBA programs in the region. Today, the School offers 10 undergraduate programs and 31 graduate programs (10 MBA/EMBA; 15 Master, MSc and MPhil; 6 PhD).

In the Financial Times Global MBA Ranking 2015, CUHK MBA is ranked 30th. In FT's 2015 EMBA ranking, CUHK EMBA is ranked 31st in the world. CUHK Business School has the largest number of business alumni (30,000+) in Hong Kong -- many of whom are key business leaders. The School currently has more than 4,500 undergraduate and postgraduate students and more than 230 students embark on an international exchange during the school term every year. Professor Kalok Chan is the Dean of CUHK Business School.

More information is available at: www.bschool.cuhk.edu.hk or by connecting with CUHK Business School on Facebook: http://www.facebook.com/cuhkbschool and LinkedIn: http://linkd.in/1Oyg6fW.

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