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Why do companies transfer the trading compartment of their common stocks[☆]

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ABSTRACT

We analyze the motives and determinants of voluntarily stock exchange section switching on the NYSE Euronext. By strategically deciding trading-section transfer when it is beneficial, managers expect to reduce their liquidity and invisibility costs, cost of capital, or their listing costs. We show that managers decide to change the trading compartment of their common stocks based on various factors including firm's size, liquidity level, debt ratio, and expected growth opportunities. Firms that move voluntarily from a less or non regulated compartments to a more regulated one are likely to have transferred to increase their credibility, improve their stocks' liquidity, re-balance their leverage, and to finance their growth opportunities. Whereas those that move their common stocks toward a less-regulated compartments do it mainly for costs saving reasons.

1. Introduction

Stock exchange section transfers have been little-documented in the literature. The few research works, which have addressed this issue, limit themselves to analyzing the market reaction to the transfer decision. Baker and Edelman (1990) and Lamba and Ariff (1997) examined the effects of stock exchange section transfer on switching stocks' returns and liquidity. Cissé and Fontaine (2015) also analyzed the price reaction to compartment transfer decision on the NYSE Euronext Paris and its consequences on switching stocks' liquidity and volatility. Campbell and Tabner (2014) investigate migrations between two sections of the London Stock Exchange by examining the effect of changes in the level of agency risk on firm value and the cost of capital.

The decision to switch trading compartment is becoming an increasingly important strategic issue for companies. Despite this importance of trading section transfer, still little is known about which reasons urge managers to switch the trading section of their stocks, and which benefits they expect to get from this operation.

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According to the previous literature in the field, our paper is the first to investigate the reasons why firms voluntarily decide to change the trading compartment of their common stocks. The paper also contributes to the debate by analyzing some common firm characteristics likely to explain the compartment transfer decision. Studying the motives and determinants of stock exchange section switching could help in better understanding of the effects of this phenomenon. This paper differentiates itself from previous studies by examining a less-known type of market transfer. Indeed, the stock exchange compartment transfer is different from initial public offering (IPO), because it is about firms that are already listed and just moving their common stocks from one trading compartment to another one within the same stock exchange. But some reasons for IPO such as increased company's stock liquidity are also reasons for stock exchange section transfers.

We begin by providing a broad picture of the benefits and drawbacks of stock exchange section transfers. Our analyses focus on the NYSE Euronext for two main reasons. First, NYSE Euronext is segmented in several trading sections. Each compartment has its own admission conditions and trading requirements, and attracts different types of firms. Furthermore, the compartment transfer is a common phenomenon on the NYSE Euronext and for the most part voluntary. From 1995 to 2012, on average, about 10% of IPOs on the NYSE Euronext were compartment transfers. This figure rose to 32% for the year 2010.

By using hand-collected data from prospectus, our analyses show that firms switching towards a high quality compartment are motivated for several reasons. Among these include the improvement of visibility; reinforcement of their credibility with customers, suppliers, and partners; increased liquidity of their common stocks; optimizing potential for appealing to the market to accompany eventual internal and external growth if required; permitting their current and future shareholders to benefit from guarantees and protections offered by a regulated market. As for companies that switch toward a less demanding compartment, they do so primarily for cost reduction reasons.

We also analyze some *ex post* consequences of compartment transfers. This analysis shows that firms switching toward high quality market compartments do so to finance their growth opportunities by raising equity capital rather than balancing their leverage. Moreover, they significantly exhibit higher net tangible assets values than their control groups.

We then turn to a deeper analysis of the determinants of compartment transfer to gain a better understanding of this phenomenon, by linking companies' decisions to switch the trading compartment of their common stocks to their *ex ante* characteristics (*e.g.*, size, stocks' market activity, growth and investment opportunity, debt level, . . .). We investigate these relationships by using company-level data. These data have been drawn from the Eurofidai and Thomson Financial databases. We find that for firms, which transfer on more regulated compartments, the probability of switching increases with size, trading volume, change in debt ratio level, return on asset, and origin trading compartment. Down-transferred firms are characterized by smaller size and lower market activity, as measured by stock turnover, trading volume, number of quotation day, and Amihud's illiquidity ratio.

In this paper, we intentionally decide to not address the underpricing effect, well summarized and documented by, for instance, Chemmanur (1993), Ibbotson and Ritter (1995), Booth and Chua (1996), Aggarwal et al. (2002), Bouzouita et al. (2015). The reason for that is most of the compartment transfers taking place on the NYSE Euronext Paris are direct listing. In other words, subsequent to transfer, the last price of quotation will be automatically the first price of quotation on the new compartment. On the other side, only 10 companies simultaneously proceeded to a transfer and seasoned equity offering (SEO). This number was not enough to examine the underpricing.

The remainder of the paper proceeds as follows. In Section 2, we examine possible reasons for switching firms to transfer their common stocks and draw testable predictions from each hypothesis. In Section 3, we provide information about the stock market (NYSE Euronext). Data used in our analysis are described in Section 4. In Section 5, we analyze the motives of firms' transfer decision using managers' *ex ante* statements. Section 6 analyzes the determinants of the decision to transfer on the basis of the firms' *ex ante* characteristics. Finally, we summarize the findings of this paper and conclude in the last section.

2. Benefits and disadvantages of stock exchange section transfers

The decision to transfer the trading compartment of a firm's stocks is very important. Before making this decision, managers must compare the benefits and costs associated with. In this section, we outline the theoretical and empirical reasons why companies may want to switch the listing section of their common stocks. Some of these reasons such as increased company's stock liquidity can be the same for IPO.

First, companies may switch their common stocks' trading compartment for financial reasons: raising money in the new section may be cheaper or more easily available. Second, a compartment transfer may strengthen the competitive position of the company in its industry, by enhancing its reputation with lenders, suppliers, employees, and customers.

2.1. Financial motives of compartment transfer: the improvement of the alternatives and terms of future funding

By switching trading section, firms may improve the terms on which they can raise capital. This motive is the strongest if the firm or its shareholders need to raise capital, while financial constraints in the origin compartment are significant.

One of the main reasons why a company may need equity funding is to undertake new investment projects. The required financing is probably going to be particularly higher for fast-growing companies and for companies that have already exhausted their borrowing capacity. Therefore, companies that switch trading compartment to raise capital should have