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Outperforming markets: IC and the long-term performance of Japanese IPOs

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ABSTRACT

This article studies the effects of disclosure practices of Japanese IPO prospectuses on long-term stock performance and bid–ask spread, as a proxy for cost of capital, after a company is admitted to the stock exchange. A disclosure index methodology is applied to 120 IPO prospectuses from 2003. Intellectual capital information leads to significantly better long-term performance against a reference portfolio, and is thus important to the capital market. Further, superior disclosure of IC reduces bid–ask spread in the long-term, indicating that such disclosures are important in an IPO setting. Analysts and investors can attain higher long-term returns by understanding IC.

1. Introduction

The efficient functioning of capital markets is dependent upon the flow of information between companies and investors, either directly or indirectly through financial intermediaries, such as analysts. Information reduces investors' perceived risk when predicting a company's future performance. Information asymmetry will always be present to some extent given that investors never have access to the same information as the top management team in a company. However, effective information disclosure practices have been shown to be advantageous both from investor and company perspectives.

In the last couple of decades, it has been hypothesized that accounting information is insufficient as standalone information for investors and analysts seeking to value companies. However, accounting information is still perceived as among the most important information constituents of the total information set. Furthermore, it has been indicated that this insufficiency with accounting information is especially problematic when a company is unknown to the investor, which is the case for companies having not been previously publically traded. The ability to attract capital is vital for many industrial sectors today, and information disclosure can reduce the perceived risk of the investors. Therefore, this article studies disclosures

Abbreviations: METI, Ministry of Economy, Trade and Industry; IAbM, Intellectual Asset-based Management; GIPID, Guideline for Intellectual Property Information Disclosure.

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made during the initial public offering (IPO) phase, when building investors' knowledge of the company is quite an intense process.

Studying voluntary disclosures in IPO prospectuses has a twofold significance. It is not just crucial for academia, but also for stakeholders in the financial markets. First, companies continuously need to pursue enhanced disclosure practices by minimizing, prioritizing, and structuring the corporate information in relation to strategy, value creation, and intellectual capital (IC), as well as environmental, social, and governance factors. This is important because companies are constantly competing for attention in a global information environment by addressing a multitude of different stakeholders who will potentially take interest in the message being conveyed. Second, an enhanced understanding of which types of voluntary information disclosure facilitate the valuation processes will positively affect the functioning of the capital markets by increasing transparency and decreasing information asymmetry (Jenkinson & Ljungquist, 2001). Many corporate intellectual capital disclosures are voluntary as mandatory measurement and recognition of intangible assets is limited (e.g. Eckstein, 2004; El-Tawy & Tollington, 2013; Zéghal & Maaloul, 2011).

Jenkinson and Ljungquist's (2001) study was among the first that illustrated how lower information asymmetry through improved disclosure practices became proxies for reducing *ex ante* uncertainty. Other seminal studies illustrate that there exist a number of other metrics which may affect the stock price performance of new listings, for example, retained ownership (Jog & McConomy, 2003), differences in institutional and legal environments (Hopp & Dreher, 2013), disclosure of earnings forecasts in IPO prospectuses (Clarkson & Merkley, 1994), and underwriter reputation (Megginson & Weiss, 1991). However, these factors have been left outside the scope of this paper as we focus on the effects of disclosing intellectual capital information on information asymmetries.

Schrand and Verrechia (2004) argue that information asymmetry between corporate management and the financial markets at the time of the IPO lead to higher costs of capital. They argue that companies can directly apply voluntary disclosure as a tool to reduce these costs. Further, they find disclosure to be negatively associated with bid–ask spread as a proxy for a company's cost of capital. In light of Schrand and Verrechia's (2004) findings, this study therefore examines the long-term stock price performance effects of intellectual capital disclosures.

Voluntary disclosure practices in Japanese annual reports were studied meticulously at a time when Japanese industrial practices were forefront in production management (e.g. Cooke, 1991). However, Japan's leadership in knowledge management and intellectual capital seems to have been caught up with by the rest of the industrialized world in the last 15–20 years, a development much aligned with the leading stock market index, the Nikkei. The timing of the dataset corresponds with a rising focus of the Japanese government on managing knowledge and intellectual capital. Under the auspices of the Japanese Ministry of Economy, Trade and Industry (METI), the "Intellectual Asset-based Management" (IAbM) guidelines were developed in October 2005. Additionally, METI started to play a central role in the World Intellectual Capital Initiative.

Although Japan has historically been strongly associated with a knowledge-society, Japanese studies focusing on the importance of voluntary disclosure for the capital market are scarce. Aspects of Japanese IPO performance have previously been examined by Dawson and Hiraki (1985), Pettway and Kaneko (1996), and more recently, by Pettway, Thosar, and Walker (2008). To the authors' knowledge, only one previous paper has examined the informational effects of the voluntary disclosures included in Japanese IPO prospectuses (Rimmel, Nielsen, & Yosano, 2009). The contribution of this study is the examination of the effects of voluntary intellectual capital disclosures on the stock price subsequent to their introduction on the stock exchange, as well as on the companies' cost-of-capital. This is accomplished by analyzing the information content of 120 IPO prospectuses of companies going public on the Nikkei Stock Exchange in 2003. In the methodology section, arguments are given for the appropriateness of precisely this data-point.

There are some limitations to the findings of this study, as the data presented only reflects a 1-year sample of Initial Public Offerings on the Nikkei Stock Exchange. Hence, the results must be read with some caution. Furthermore, it might have been problematic if the Japanese stock market environment in 2003 did not reflect that of a normal "over the business cycle" year. However, this year has been chosen specifically to overcome such problems. Further words of caution for our conclusions lie in the applied auctioning methods within the IPO market. In 2001, book building[1] was the method applied considerably more than other possible auction methods for IPOs in Japan. Consequently, market participants may have acted differently than they would have otherwise or acted still in accordance with traditional behavior.

The remainder of the paper is structured as follows. Section 2 describes the theoretical foundations of the study and leads to the formulation of the hypotheses concerning IPOs underpricing and cost of capital measured as bid–ask spread in stock across time. In Section 3, the applied research methods are explained, while Section 4 contains the results of the analysis. Finally, the discussion and concluding remarks are contained in Section 5.

2. Disclosure effects on initial valuation and cost of capital

The seminal literature advises us that voluntary disclosures are expected to lower the cost of equity capital (see Verrecchia, 2001) because increased disclosure reduces information asymmetry and tends to enhance stock market liquidity by

[1] In book building, the underwriter seeks indications of interest from investors and sets a minimum and maximum price for the IPO. Institutional investors submit nonbinding price and quantity indications to the underwriter. The underwriter, in selecting the final offer price, can accept the quantity indications above the price and sells any remaining shares to the public (Kutsuna, Smith & Smith, 2009, pp. 1130–1140).