International Journal of Hospitality Management 76 (2019) 71–82

Contents lists available at ScienceDirect

International Journal of Hospitality Management

journal homepage: www.elsevier.com/locate/ijhm

From finance to marketing: Initial public offering ownership overhang and marketing in the hospitality industry

Minghui Ma[a], Jian Huang[b], Shan Lin[c], Shuai Yang[d,*]

[a] School of Business, State University of New York at New Paltz, United States
[b] College of Business and Economics, Towson University, United States
[c] College of Business, Lewis University, United States
[d] School of Business and Management, Donghua University, China

ARTICLE INFO

JEL Classifications:
M30
G14

Keywords:
Marketing-finance interface
Hospitality
Marketing intensity
Initial public offering (IPO) overhang

ABSTRACT

Hospitality firms spend significant amounts on marketing activities post-IPO. It is critical to understand the driving force behind these firms' aggressive marketing strategies. This study examines the impact of Initial Public Offering (IPO) overhang on the marketing activity of newly public firms in the U.S. hospitality industry. IPO overhang measures the ownership retained by pre-existing shareholders who are mostly corporate insiders. Our results indicate that IPO overhang is positively associated with post-IPO marketing intensity up to three years post-IPO. Further, the marketing activity by newly public firms is associated with higher equity market liquidity, consistent with the view that marketing activity promotes equity market liquidity and thus facilitates insiders' exit. Our findings provide an avenue for IPO firms to manage the negative price impact of corporate insiders' cash-out, and a partial explanation for newly public firms' aggressive investments in marketing.

1. Introduction

With a significant capital infusion from Initial Public Offerings (IPOs), hospitality firms spend aggressively on marketing during the post-IPO period, including advertising, market research, communications, and other marketing efforts. For example, Las Vegas Sands Corporation spent over $120 million on marketing after its IPO in 2004 to "advertise in many types of media…, promote general market awareness of our properties…, and actively engage in direct marketing as allowed in various geographic regions (Las Vegas Sands Corp. Annual Report, 2004)." The marketing expenditures can be critical to newly public firms' development. For example, Hsu and Jang (2008) examine the relation between advertising expenditures, risk, and intangible value of restaurant firms. Their results suggest that marketing activities are critical in generating intangible value for restaurant firms.

However, despite the aggressive investments in marketing and its value implication, few studies have examined IPO and marketing activities of hospitality firms post-IPO. Jang and Park (2010) find that less than 2% of hospitality financial research has focused on IPOs out of the 113 articles they investigated. Further, we find that none of these studies address the marketing activities surrounding the critical event of going public. Along the same line, Jang et al. (2013) point out that "contemporary management strategies increasingly seek to enhance shareholder value via marketing strategies, which suggests the need for further exploration of the connections between marketing efforts and financial metrics." Despite this increased attention, "little research in the academic fields of tourism and hospitality has focused on bridging the marketing and finance." Similarly, Downie (1997) stressed the seriousness of conflicts between marketing and finance functions in the hotel industry. With a marketing-finance interface, a firm can better understand and reconcile the conflicts between these two internal functions.

We aim to be in the first cohort to investigate post-IPO marketing activities in the hospitality industry. While Kurt and Hulland (2013) find that newly public firms generally "adopt a more aggressive marketing strategy" shortly after an IPO, a more recent study by Saboo et al. (2016) documents that 37% of IPO firms engage in the myopic practice of "curtailing their marketing budgets." Therefore, it would be natural to explore how these young firms make decisions regarding their marketing budgets and strategies.

Marketing spending, like investments in research and development, can be largely agency-driven (Saboo et al., 2016). A central premise of the agency theory is that managerial decisions, including marketing-related ones, are strongly influenced by the ownership status of each decision maker (Jensen, 1998). We investigate the impact of share ownership retained by pre-IPO shareholders on post-IPO marketing

* Corresponding author.
E-mail addresses: mam@newpaltz.edu (M. Ma), jhuang@towson.edu (J. Huang), linsh@lewisu.edu (S. Lin), shuai.yang@dhu.edu.cn (S. Yang).

https://doi.org/10.1016/j.ijhm.2018.03.019
Received 17 June 2017; Received in revised form 21 March 2018; Accepted 31 March 2018
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strategies. Ownership retained by pre-IPO shareholders relative to outside shareholders is measured by IPO overhang, and these pre-IPO shareholders are influential in the corporate decision making process, including executives, directors, founders, venture capitalists and other blockholders. We hypothesize that pre-IPO shareholders with high share retention have a strong motive to pursue aggressive post-IPO marketing activities.

First, post-IPO marketing activity enhances secondary market liquidity by increasing visibility among investors and resolving information asymmetry. For example, Grullon et al. (2004) argue that investors build their portfolio at least in part based on their familiarity with the portfolio firms. Luo (2008) shows that pre-IPO marketing activity can provide more information about the true value of the firms and resolve information asymmetry.

Further, the equity market liquidity facilitates the exit of pre-IPO shareholders with retained ownership post-IPO. Pre-IPO shareholders include high-level executives and directors whose personal wealth is primarily tied up in the firm, and they are more influenced by the ease of exit and the negative price impact at the time of cash-out. We thus argue that a higher share overhang leads to more aggressive marketing activity post-IPO, and the post-IPO marketing activity is in turn associated with higher secondary market liquidity which benefits pre-IPO shareholders' exit.

We are now in a position to preview our empirical findings regarding post-IPO marketing activity. We find that, in the hospitality industry, IPO share overhang is significantly related to post-IPO marketing intensity for up to three years after an IPO. In addition, post-IPO marketing intensity is positively associated with the equity market liquidity, consistent with the view that marketing activity serves as an information channel and increases visibility among investors.

Our findings provide an avenue for IPO firms to reduce the negative price impact of corporate insiders' cash-out. By heavily marketing, firms can increase their secondary market liquidity to facilitate the cash-out. Further, our findings provide a partial explanation as to why newly public firms aggressively invest in marketing. These young hospitality firms devote over $19 million, on average, to marketing activities in the first year post-IPO, and more in the following years. The aggressive marketing can be partially explained by the fact that the marketing investment is utilized to increase stock liquidity and to facilitate influential corporate insiders' exit upon the stock's lockup expiration.

The rest of the paper is structured as follows. In Section 2, we review the literature with a view to provide the appropriate background for our research and develop the two major hypotheses tested herein. Then, we describe our data and sample characteristics. Next, we present results pertaining to the empirical test of our key theoretical proposition. Finally, we provide a summary and discuss the implications and limitations of our research.

2. Hypotheses

2.1. A glossary of pre-IPO shareholders, overhang, and lockup

Pre-IPO shareholders include executives, directors, founders, venture capitalists and other blockholders (see Fig. 1). An IPO provides the first opportunity for some pre-IPO shareholders to sell shares to the public, and then cash out.

However, as indicated by Field and Hanka (2001, p. 476), during their sample period of 1988–1992, on average 95 percent of the shares held by pre-existing shareholders were locked up. Thus, they could not sell their shares before the unlock date. Officers and directors as well as blockholders who hold 5% or more ownership are normally locked up for a certain period of time. The exempted parties who are not subject to the lockup provisions are mostly atomistic shareholders, which include, for example, "low-level employees as well as recipients of friends and family shares." The pre-IPO shareholders with shares retention are mostly officers, directors, founders, and blockholders who all possibly have an influence on the firm's corporate strategic decision making, including the marketing strategies.

Consistent with the previous literature on IPO lockup provisions, the lockup periods in our sample are typically for six months, and can also be as long as two to three years. Pre-IPO shareholders have a strong desire to sell their shares upon the expiration of lockup periods. Cao et al. (2004) posit that the sales upon lockup expiration can be driven either by pre-existing shareholders' belief that the stock is over-valued ("information trades"), or by their own need to diversify their wealth ("diversification trades"). As pre-existing shareholders' wealth is largely tied up in the firm, most sales may be defined as "diversification trades." "Information trades" also exist as pre-existing shareholders can take advantage of the first opportunity to cash out based on their estimate of the firm valuation.

2.2. Share overhang and demand for equity market liquidity

Fig. 2 demonstrates the development of our hypotheses. Pre-IPO shareholders with share retention sell aggressively in the post-IPO stage, especially upon the expiration of lockup periods. Cao et al. (2004) find that 23% of lockup expirations are followed by disclosure of insider selling. Similarly, Field and Hanka (2001) report a permanent 40 percent increase in trading volume upon the expiration of lockup periods.

When more shares become available to the public, there is normally a drop in share price as documented by Bradley et al. (2001), Brav and Gompers (2003), and Field and Hanka (2001). For example, Field and Hanka (2001) report an abnormal return of −1.5 percent within three days around the lockup expiration which is non-trivial.

Although shareholders generally all value equity liquidity (e.g., Booth and Chua, 1996), a liquid equity market is especially preferable for pre-IPO shareholders who have strong incentives to cash out when their shares become available for trading. Equity market liquidity facilitates the exit of pre-IPO shareholders who retain their ownership following the IPO. Because they have locked-up significant wealth in the firm, these shareholders would find it more difficult to sell their shares if the market for the stock is not sufficiently liquid at the time of their post-IPO cash-out, as doing so would lead to a greater negative price impact. Therefore, we argue that pre-IPO shareholders value and benefit from enhanced equity market liquidity more than other investors as pre-IPO shareholders' personal wealth is largely tied up in the firm, and they are more influenced by the ease of exit and the negative price impact at the time of cash-out.[1]

At the same time, pre-IPO shareholders, compared with other shareholders, are typically influential in making corporate policies, including marketing-related one, as they are powerful venture capitalists, blockholders, high-level executives, directors, and founders. These shareholders provide funding, leadership, and advice from very early stages of the firm's life and often occupy board positions, influencing managerial compensation and career outcomes (Hellmann and Puri, 2000, 2002).

We, hence, argue that more share retention by pre-IPO shareholders is associated with higher demand for a liquid equity market after an IPO.

[1] An anonymous referee points out that investors all value and benefit from equity market liquidity as it is synonymous with the demand for its assets in the market, and this demand is dictated by the current and expected future performance of the firm, which is influenced by firm's marketing activity. Acknowledging this, we posit that pre-IPO shareholders may have an even stronger motive and ability to pursue a more liquid market as they aggregately hold two to three times as much ownership as the rest shareholders (Dolvin and Jordan, 2008).

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