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The impact of local governance institutions on foreign market listings: The case of Chinese firms ☆

Abigail S. HORNSTEIN *

Department of Economics, Wesleyan University, 238 Church Street, Middletown, CT 06459, United States

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ABSTRACT

This paper exploits the substantial variation in market institutions across provinces in China to examine the impact of institutional quality on foreign listing. Firms that are listed on the U.S. and U.K. exchanges are more likely to come from better regulated provinces and tend to be at the top of a corporate pyramid. However, though the impact on firm performance of market institutions and pyramidal affiliations persists briefly post-listing with firms recording lower EPS and higher raw returns in the first year, it does not help predict whether firms remain listed abroad in 2012. Thus, we conclude that headquarters' market institutions shape a firm through time of listing and have diminished influence over time.

1. Introduction

Economic institutions are generally measured and studied at the country-level, a convention that may be best exemplified by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998). Many firms seek foreign equity listings in order to access larger pools of capital and facilitate long-term growth while increasing the firm's reputation (Gozzi, Levine, & Schmukler, 2008; Pagano, Röell, & Zechner, 2002; Stulz, 1999). Doidge, Karolyi, and Stulz (2011) find that countries with stronger market institutions have more domestic IPO activity and lower levels of foreign IPO activity. China is an anomaly as even while there is domestic variation in the quality of economic institutions, and many firms, particularly from the provinces with stronger institutions, are listed domestically, many firms have nonetheless sought overseas listings, again including many from the provinces with stronger institutions. We therefore investigate whether domestic variation in market institutions affects foreign equity listing patterns, and whether these institutions have a long-term effect on these firms' subsequent behavior.

Firms with better local governance institutions may have better internal governance and thus be more attractive to local investors, thus decreasing the need to seek investors abroad (Doidge et al., 2011). While the Chinese markets are now among the world's largest markets, they are inefficient due to IPO underpricing, restrictions on share issuance, trading, and ownership, and

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* Tel.: +1 860 685 3049.
E-mail address: ahornstein@wesleyan.edu.

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the government's ability to delist listed firms even when they comply with all requirements and remain profitable and actively traded (Chan, Menkveld, & Yang, 2008). Chinese firms might therefore benefit from listing overseas, and an increasingly large number of such firms have done so over the last decade.[1]

Around the world most firms that eventually acquire foreign listings first go public at home, and yet this is not the case with Chinese firms. The most common listing pathway is for firms to list on a home exchange, with a subset of these firms subsequently cross-listing shares on a foreign exchange, and very few of these firms later withdraw from their home market.[2] Thus, the Chinese phenomenon examined in this paper is distinctly different and merits analysis. As is revealed in our data set, more than 90% of the Chinese firms that are only listed on a foreign exchange, primarily in Hong Kong and Singapore, do not also have a listing domestically in the mainland.[3] Thus, investors have less information to use when evaluating a Chinese firm's foreign IPO.

We examine determinants of Chinese firms' decision to go public in particular countries and their subsequent performance. It is possible that these corporate decisions are affected only by easily observed attributes such as financial performance as are commonly examined in studies of corporate listing decisions, both domestically and in the cross-listing context. However, when looking at Chinese firms there is a second layer of characteristics that may be at least as important and yet not be visible to foreign investors: whether a firm belongs to a pyramid and the quality of local governance institutions. The data set used herein is restricted to Chinese firms that are only listed abroad as foreign investors may also be less familiar with the variation in domestic institutions even though these institutions shape listing patterns (Doidge et al., 2011).

Firms that have better local governance institutions may find it easier to meet the regulatory requirements for listing on foreign exchanges and thus be more inclined to list shares abroad (Chhaochharia, Kumar, & Niessen-Ruenzi, forthcoming; Shi, Magnan, & Kim, 2012). On the other hand, firms with good internal governance that are in locations with poor local institutions may wish to list shares abroad in order to signal that the firm itself is of a higher quality (Siegel, 2005) or enjoy governance spillovers from the firms already listed on the foreign exchange (Sun, Tong, & Wu, forthcoming). These hypotheses suggest that local governance institutions could have an impact on the volume and pattern of foreign equity listings in general, while leaving open the question of whether these institutions could affect firms' behavior after listing abroad.

While there is a voluminous literature on cross-listings little has been written about firms that have only foreign listings due to the small number of such firms. Two studies of firms that have only foreign listings are Blass and Yafeh (2001) of Israeli firms listed on U.S. exchanges, and Sun et al. (forthcoming) on Chinese state-owned firms listed in Hong Kong.[4] This study is broader as it considers all firms from one country that are listed on any foreign exchange, yielding a much larger and more diverse data set, and yet the results of this study complement and extend the traditional approach of studying all publicly-listed firms from a particular country (e.g., Zhang & King, 2010).

Two explanations for why Chinese firms list on particular foreign exchanges are explored in this paper. First, a large literature (e.g., La Porta et al., 1998) has found that firms are more profitable and better governed when they are located or listed in countries with better regulatory and operating environments. China has significant domestic variation in the quality of regulatory and operating environments, both cross-sectional and inter-temporal, which can affect routine corporate behavior such as earnings management and financial disclosure, as confirmed by empirical studies such as that of Jian and Wong (2010).[5] Home country legal institutions affect cross-listed firms' behavior (Shi et al., 2012), and thus we examine whether intra-national differences in legal institutions might also affect activity abroad of firms from a common home country.

Second, foreign investors may have greater difficulty interpreting a firm's control and management structure if the firm belongs to a pyramid.[6] 60% of Chinese firms are part of corporate pyramids (He, Rui, & Zha, 2010). Insiders often amass private benefits from their control of corporate pyramids (Morck, Wolfenzon, & Yeung, 2005) and yet pyramidal affiliations are not always easy for investors to discern. When a firm belongs to a pyramid, conventional firm-level measures of corporate governance are no longer appropriate as the firm's raison d'etre has changed (Morck et al., 2005; Peng, John Wei, & Yang, 2011).

Using a data set of 291 Chinese firms that obtained sole listings abroad during 2002–2007 both hypotheses are confirmed: the quality of domestic institutions is directly associated with listing patterns, and markets that cater primarily to investors who are less familiar with corporate pyramids (i.e., non-Asian exchanges) attract fewer such listings. However, parents of pyramids are particularly likely to list on the U.S. and Singapore exchanges. In addition, firms report slightly lower earnings per share (EPS) post-listing and higher raw stock returns after listing abroad when they come from provinces with more market intermediaries, suggesting that they may be more diligently adhering to accounting laws. These results are consistent with the evidence that

[1] The firm's decision to list abroad is considered endogenous as the process of listing in the domestic stock exchanges is well known to be very extended and uncertain. Thus, many firms may consider a foreign listing to be a faster, safer way to gain equity capital and maintain an exchange presence.

[2] Two-thirds of the firms that issued shares abroad after listing domestically are listed in Hong Kong.

[3] There are persistent differences between the Chinese firms that list on domestic exchanges, cross-list shares abroad, and those that only list shares abroad (Zhang & King, 2010). Firms that list on only one exchange need to comply with just one set of requirements while firms that list on both a domestic Chinese exchange and a foreign one must meet all regulatory and compliance requirements of both exchanges.

[4] These are the only studies we are aware of that examine only firms that list shares on foreign exchanges. However, this phenomenon of firms listing shares only on a foreign exchange is becoming less rare as is shown by the 2011 decision of Samsonite (U.S.) to list shares only in Hong Kong.

[5] Companies have some latitude with regard to the timing of revenue and expense recognition, particularly when they involve one-time or extraordinary charges, and the practice of manipulating how data are reported to support a firm's financial reputation is generally called earnings management.

[6] The terms pyramid, business group, and holding company are often used somewhat interchangeably in the literature. We use exclusively the term "pyramid" as that is most commonly used in the China context.