



Controlling shareholders and market timing: Evidence from cross-listing events



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ABSTRACT

We find partial support for a permanent increase in firm value following U.S. cross-listings. Cross-listed firms with capital-raising intentions on U.S. exchanges and firms cross-listing after the Sarbanes-Oxley Act exhibit an increase in firm value. Yet, investors are worse off in the long run when owning insider-controlled cross-listings. Compared to non-insider-owned cross-listings, insider-owned firms have a greater rise in value around the cross-listing year but also a larger decline in the post-cross-listing years. In fact, insider-owned firms lose value by the fifth year, compared with their value before cross-listing. Lastly, we show that liquidity and visibility enhance the value of cross-listings.

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1. Introduction

Firms around the world have benefitted from reduction in capital barriers in the last few decades. Specifically, emerging-market firms have become more open to the world economy by cross-listing in more developed stock markets. For instance, the U.S. equity market is the most popular destination for foreign firms looking to cross-list their stock abroad. Cross-listed firms deposit part of their shares in investment banks which subsequently issue American depository receipts (ADRs)¹; ADRs trade in the U.S. similar to shares of U.S. firms.² Particularly after the early 1990s, there has been a rise in cross-listings from emerging countries outpacing developed-countries cross-listings due to the greater expectations for benefits from listing on more developed stock exchanges such as those in the U.S. (Esqueda & Jackson, 2015).

There is a consensus in the literature regarding improvements in financial performance in the short-run; however, the long-run

consequences of cross-listing are controversial. We attempt to disentangle the inconclusive evidence on the permanent increase in valuation following U.S. cross-listings. Our main contribution lies on evaluating the effect of ownership structure, a proxy for potential agency issues, on the value of cross-listed firms. On the one hand, asset pricing theories indicate that market value increases due to cross-listings should be permanent as investors perceive reduction in risk; on the other hand, the market-timing hypothesis suggests that the increase in firm value is not permanent as managers choose to cross-list after periods of extraordinary performance.

Extant literature describes reasons to cross-list in the U.S. For instance, early cross-listing literature claims that firms cross-listing in the U.S. reduce their cost of capital (Stapleton & Subrahmanyam, 1977; Errunza & Losq, 1985; Alexander, Eun, & Janakiraman, 1988). Other authors find that cross-listed firms increase liquidity (Karolyi, 1998; Foerster & Karolyi, 2000), enhance investor recognition and shareholder base (Foerster & Karolyi, 1999), improve information transparency (Lang, Lins, & Miller, 2003; Karolyi, 2006; Fernandes & Ferreira, 2008), and increase shareholder protection by bonding to stricter regulation (Stulz, 1999; Coffee, 1999, 2002; Doidge, Karolyi, & Stulz, 2004).³ Specifically, the increase in shareholder protection implicit in the bonding hypothesis has recently been the subject of abundant research due to its relevant

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¹ ADRs are negotiable certificates issued by a depository bank and represent rights to the cash flows of non-U.S. firms. ADRs were first created in 1927 by J.P. Morgan as a means for U.S. investors to participate in the London Stock Market. However, it was after 1990 that the popularity of ADRs increased among firms and investors.

² The U.S. offers four types of ADRs. Type I trade only over-the-counter (OTC). Type II and type III ADR programs are U.S. exchange traded, and Rule 144-A ADRs (PORTAL) are private offerings exclusive to qualified investors.

³ Karolyi (2006, 2012) provides a detailed description of these cross-listing hypotheses.

implications and the current debate is still inconclusive (Karolyi, 2012). Despite the documented findings, there is no evidence that the cross-listing outcomes benefit investors in the long run. For instance, Licht (2003) calls into question the bonding benefit and argues that cross-listings are insensitive to crucial features of the U.S. securities regulation as corporate insiders from foreign firms are subject to less restrictive provisions of SEC rules. Similarly, Siegel (2005) mentions that, despite being subject to SEC regulation, foreign firms can still act opportunistically as there is a low level of securities law enforcement toward foreign firms. We posit that when shareholders' protection is low, managers pursue cross-listings even if it is not in the best interest of shareholders, i.e. there is not a value increasing outcome. Therefore, using cross-listed firms, we test the bonding hypothesis (firm value increases in the long run) versus the market-timing hypothesis or "avoiding" hypothesis put forward by Licht (2003) (firm value does not increase in the long run).

The cross-listing premium is defined as the increase in firm value due to the cross-listing event. Given the existence of a self-selection bias, we employ comparable non-cross-listed firms to measure the change in value due to cross-listing. In this paper, we study the long-term increases in value of foreign firms after cross-listing their stocks in the U.S. Specifically, we measure the benefit for shareholders in terms of Tobin's q , a widely-used proxy for firm value, due to an improvement in the shareholder protection following a cross-listing event.⁴ In the context of the bonding hypothesis, we measure the implications of ownership structure, a proxy for corporate governance, on the long-term performance of cross-listed firms. The effect of ownership structure on the value of cross-listings has received some attention from researchers; however, extant literature mostly focuses on its short-term effects, makes little distinction on firm-level corporate governance, and provides modest evidence on firm-value over multiple cross-listing years.

Exploring the long-term performance of emerging-market firms has become particularly relevant for U.S. investors due to the significant number of firms that cross-list in the U.S. and their substantial impact on financial markets. Additionally, it is important for managers and practitioners to know whether there is a long-lasting benefit from cross-listing in the U.S. King and Segal (2009) provide some background for this paper. Our manuscript enhances their findings in several ways. First, their focus is on Canadian cross-listed firms whose characteristics differ greatly from our sample of emerging economies. For instance, less-developed countries have a weaker level of regulation (Doidge et al., 2004), more ownership concentration (La Porta, Lopez-de-Silanes, & Shleifer, 1999; Claessens & Yurtoglu, 2013), and existing regulations are less likely to be enforced (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000). These differences might impact previous findings on developed countries cross-listings as the improvement in shareholder protection described by the bonding hypothesis is stronger in emerging-market cross-listings. In particular, La Porta et al. (2002) find that the degree of shareholder protection has a significant impact on foreign-firm valuations.

Second, our paper adds to the cross-listing literature by documenting the effect of liquidity on the long-term post-cross-listing value. Dodd, Louca, and Paudyal (2015) note that the increase in liquidity is particularly relevant for U.S. cross-listings. Specifically, King and Segal (2009) do not include measures to control for liquidity effects on firm value in their study as Mittoo's (2003) argues that, due to integration with the U.S. stock market, liquidity has a negligible effect on the value of cross-listed Canadian firms; however, the effect of liquidity on the value of firms from emerging economies might differ from Canadian firms due to the different and time-varying degrees of market integration (Esqueda, Assefa, & Mollick, 2012). Third, we explore the effect of the enhanced reporting requirements and corporate governance

mandates, encompassed in the Sarbanes-Oxley Act (SOX), on the long-term value of emerging market cross-listings. This shift in U.S. corporate governance, affecting exchange-traded cross-listings, represents a structural break for bonding hypothesis testing. For instance, Esqueda and Jackson (2015) suggest that managerial opportunism of cross-listed firms decreases after the enactment of the SOX. To our knowledge, our study is the first to analyze the behavior of the long-term value of emerging-market cross-listings in a comparable framework.

This paper is presented in the following order. Section 2 defines our main research questions. Section 3 describes the sample and econometric technique. Section 4 discusses our findings and potential implications. Section 5 presents the concluding remarks.

2. Hypothesis development

Evidence suggests that, in the long run, investors are not able to consistently earn positive abnormal returns by holding shares of newly cross-listed firms. For instance, Foerster and Karolyi (2000) find that firms underperform a benchmark three years after cross-listing; however, firms with high liquidity have positive abnormal returns. Mittoo (2003) finds that Canadian firms underperform a benchmark index by the third post-cross-listing year. Sarkissian and Schill (2009) find no abnormal returns for firms that list abroad during the ten post-cross-listing years. Luo, Fang, and Esqueda (2012) show that Chinese firms listed on U.S. exchanges underperform matching firms three years after the listing event. Lastly, Esqueda and Jackson (2015) find that firms cross-list following periods of abnormal returns and, particularly, insider-owned cross-listings are not able to maintain the pre-cross-listing returns. We can, however, explain the lower returns as a consequence of the decrease in risk. For instance, Gozzi et al. (2008) state that when firms "bond" themselves to higher corporate governance standards, they are subject to a lower cost of capital. Consistent with this argument, Doidge et al. (2009) document an average 37% increase in value (short-term) after a firm is cross-listed; however, on the long-run, the evidence is mixed. For instance, O'Connor (2009) finds that firm value increases only after the fifth year for exchange-traded firms and OTC cross-listings. King and Segal (2009) find that Canadian firms have a permanent increase in valuation if they increase investor recognition or have a dual-class share structure.

Previous findings about the relationship between firm value and U.S. cross-listings may be influenced by the fact that firms have been often considered homogenous regarding their corporate governance. Heterogeneity of firms' corporate governance is supported by Klapper and Love (2004), who find a wide variation of corporate governance across firms with the same legal framework. Therefore it is necessary to consider shareholder protection at the firm level. For instance, O'Connor (2012) finds that only firms offering strong corporate governance benefit from becoming investable. Whether there are permanent gains from cross-listing is inconclusive in the extant literature.

The bonding hypothesis implies that shareholders benefit as firms improve shareholder protection following a U.S. cross-listing (Doidge et al., 2004). Such improvement in corporate governance is expected to permanently increase firm value (i.e. a permanent cross-listing premium) and therefore, the value of cross-listed firms should be permanently superior to non-cross-listed firms (Doidge et al., 2009). Specifically, controlling insiders try to maximize the value of their stake in the firm (k) as shown in the following equations based on Doidge et al. (2004).

$$\text{Max}_f k \left(C - fC - \frac{1}{2}bf^2pC \right) + fC \quad (1)$$

where,

k is the equity ownership in the firm

f the controlling shareholder diverts a share of the firm

C cash flow the controlling shareholder take for himself before distributing the rest as dividends

⁴ Lang et al. (2003), Doidge et al. (2004), Gozzi, Levine, and Schmukler (2008), Doidge, Karolyi, Lins, Miller, and Stulz (2009), King and Segal (2009), and Wang and Esqueda (2014) use Tobin's q as a measure of value of cross-listed firms and La Porta, Lopez-de-Silanes, et al. (2002) and Lins (2003) use Tobin's q to measure the value of foreign firms.

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