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Competitive valuation effects of Australian IPOs☆

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ABSTRACT

This study examines the valuation effects that Australian initial public offerings (IPOs) have on industry competitors and to what extent this can be explained by the IPO firm's corporate governance profile and the intended use of their offer proceeds. Using a sample of 106 IPOs between 1999 and 2009, the results indicate that companies experience negative stock price reactions to the completion of an IPO in their industry on days leading up to and including the event date. The multivariate results show that in relation to corporate governance factors, both board size and CEO share ownership exhibit negative relationships with rival firm abnormal returns. Moreover, IPOs which disclose either investment, or both debt reduction and investment as the intended use of proceeds result in a greater negative price impact upon rival firms.

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1. Introduction

Information transfer occurs when a firm-specific announcement has wider implications for the future expected cash flows and/or cost of capital of other similar firms (Jorion & Zhang, 2007). The objective of this study is to examine one particular type of information transfer — namely, whether initial public offerings (IPOs) have a valuation impact on the competing publicly listed companies in the same industry. We study this in the Australian setting. Prior studies such as Firth (1976) indicate that firm-specific events have price implications for close competitors. Moreover, numerous studies have since analysed the reaction among rival firms, including extensive theoretical developments (e.g., Braun & Larrain, 2009; Jorion & Zhang, 2007; Slovin, Sushka, & Bendeck, 1991).

Recent literature has developed the concept of information transfer by examining a broad range of corporate events, while distinguishing between two contrasting effects: a negative competitive effect versus a positive contagion effect. The contagion effect implies a positive correlation in the expected cash flows between the firm for which an event has taken place and its competitors. This is the implicit effect observed by Foster (1981) who shows that better than expected earnings announcements result in a positive share price movement for the announcing firm and its competitors. Conversely, the competitive effect implies a negative correlation between the expected cash flows of the specific firm and its competitors. This implies that competitors will experience a stock price decline (increase) when the announcing firm has positive (negative) news (Jorion & Zhang, 2007). This can be interpreted as the share price of rival firms reacting to either an increase or decrease in the overall level of competition.

One corporate event which has received little attention regarding information transfer is company IPOs. An IPO is a major occurrence during the operating life cycle of a firm and, depending on the circumstances, can lead to significant operational and structural changes. Recent empirical work on the issue of information transfer surrounding IPOs has provided mixed results. Akhigbe, Borde, and Whyte (2003) argue that both competitive and contagion effects are evident in the reaction of rival firms, yet, they offset each other in a manner which leads to a negligible overall effect. They suggest that the positive contagion effect is borne from the optimism conveyed by managers of the IPO, whereas the negative competitive effect stems from the potential increase in competition. While it seems plausible that both forms of information transfer may take place during an IPO listing, recent literature has focused on the competitive effect for which a strong theoretical foundation exists. In this regard, Hsu, Reed, and Rocholl (2010) provide empirical evidence of the

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competitive effect at the time of an IPO listing in the US setting. Specifically, their results show a negative (positive) reaction for industry rival firms during an IPO completion (withdrawal), both of which are consistent with the competitive hypothesis.

Our study is similar to Hsu et al. (2010) and Akhigbe et al. (2003) in that it also examines the valuation effects that IPOs have on industry rivals using an Australian sample. Given, the relatively limited literature regarding the above issue coupled with previous mixed findings, we shed further insights into the dominant form of information transfer from an IPO listing. In addition, this study contributes to the existing literature by examining the relevance of characteristics relating to the IPO firm itself on the competitive effect. In particular, we examine the effects of the IPO firm's corporate governance profile (e.g., board size, independence and CEO ownership) and the intended use of offer proceeds to assess what role they play in the process of information transfer. There are various factors relating to rival firms, to the IPO firm and to the broader industry which all have the potential to drive the competitive effect stemming from an IPO. While previous studies have addressed both rival firm and industry specific factors, to the best of our knowledge no evidence exists regarding the competitive effects associated with IPO specific characteristics.

What then is theoretical underpinning for the premise that IPOs have the potential to induce a negative competitive valuation effect among rival firms? Stoughton, Pong, and Zechner (2001) explore the product market motive for going public in a theoretical setting and argue that only firms with high quality products will list. By going public, a company is signaling that it is willing to subject itself to the close scrutiny of external parties in the marketplace, to gain perceived competitive advantages from the listing. This suggests that it is more likely that high quality firms will go public which should pose a greater competitive threat to already public firms (Stoughton et al., 2001). Central to their model is the notion that firms become more competitive after they list due to the additional competitive advantages accruing to them. One of these advantages is the reduction of idiosyncratic risk from the owner's perspective which allows for a more aggressive output strategy, thus reducing the equilibrium production level of rival firms (Chod & Lyandres, 2010). Maksimovic and Pichler (2001) provide further motivation for the negative reaction in their theoretical study which looks at firm financing and the valuable information disseminated during an IPO. They suggest that when a firm goes public, strategic comparative advantages are indentified within an industry which may allow some firms to increase their efficiency.

While it is possible that both competitive and contagion effects stem from an IPO, we focus on specific IPO characteristics which might influence the competitive effect. This is particularly motivated by the results in Hsu et al. (2010) who, aside from showing a negative price reaction of industry competitors around IPOs, also show longer-term deterioration in their operating performance. The principal source of information relating to the IPO is the prospectus which, by law, must contain considerable detail with regard to the firm and its operating environment (Bhabra & Pettway, 2003). Assuming that IPO-specific factors matter to varying degrees when explaining information transfer, the prospectus presents an important potential source of explanatory power regarding the effects of competitive information transfer. Akhigbe et al. (2003) show that such factors are relevant by finding significance for a variable relating to the IPO's intended use of proceeds.

We study two particular areas of the prospectus, which given previous literature, might have some impact upon the competitive information transfer during an IPO listing (Jensen & Meckling, 1976; Leland & Pyle, 1977; Myers & Majluf, 1984). First, we examine disclosure regarding the issuing firm's corporate governance profile given the public attention on the relevance of corporate governance on the process of firms' various decision making. Corporate governance characteristics have long been tied to firm performance due to the existence of agency costs which occur when there is divergence between manager and shareholder objectives (Jensen & Meckling, 1976).[1] Numerous mechanisms aimed at reducing agency costs have been developed at the firm level, most with the purpose of realigning managerial and ownership objectives. Information regarding such policies is generally given considerable prominence in an IPO prospectus, thus it can serve to provide a strong source from which competitive information transfer develops.

A central reason underpinning the importance of an IPO firm's corporate governance profile in relation to competitive information transfer is summed up by Dennis (2001) who comments on the gradual effects of agency costs. For a firm to operate efficiently, it must develop products with appropriate cost structures that result in the production of a competitive product. If firms are unable to perform this basic task due to inefficiencies stemming from agency costs, their competitive position within the industry could become considerably weakened. Therefore, IPO firms which display corporate governance characteristics that have been shown to mitigate agency costs could pose a more credible threat to competitors, thus partially explaining the degree of any competitive information transfer.

In addition to the possible signals which stem from the governance structure, Leland and Pyle (1977) show that firm quality can be conveyed through the level of ownership retention, which in the IPO setting is also outlined in the prospectus. Therefore, to the extent that the competitive threat posed by an IPO firm is linked to its quality, retained ownership could further impact upon the degree of competitive information transfer observed through rival firm reactions.

The other key area of the prospectus which has the potential to affect rival firms through competitive information transfer is the disclosure regarding the intended use of IPO proceeds because it can receive considerable attention in company prospectuses. While it is not compulsory to set out specific dollar amounts regarding the use of offer proceeds, they must provide basic detail as to the purpose of the offer (ASIC Regulatory Guide, 2010). To this end, IPOs can serve the purpose of providing funds for specific expansion, debt reduction or they may simply provide the owners with an avenue to exit their investment. Importantly, there is substantial variation in the uses of funds for Australian IPOs, hence, its inclusion in this study is justified. Such information could have direct implications for rival firms given the findings of several studies (e.g. Myers & Majluf, 1984), who theorize that when raising capital, firm owners will only disclose specific investment intentions when the project is of high quality. This prediction stems from information asymmetry between owners of the firm and prospective investors, yet the implications might also extend to information transfer. If specific investment projects are announced for an IPO, the effect among rival firms might be magnified to the extent that the issuing firm's quality is associated with its competitive threat.

Using a sample of IPOs in Australia and related industry competitors over the period 1999 and 2009, the results in this study confirm that industry competitors exhibit negative stock price reaction around IPOs. In addition, analysis of potential cross-sectional determinants shows that in relation to corporate governance factors, both board size and CEO share ownership exhibit negative relationships with rival firm abnormal returns. Furthermore, IPOs which disclose either investment, or both debt reduction and investment as the intended use of proceeds result in a greater negative price impact upon industry rival firms.

The remainder of the paper is structured into five sections. Section 2 presents a brief review of literature on IPOs which help in formulating the relevant hypotheses. Section 3 describes the data and econometric methods. Section 4 provides the empirical results, while Section 5 provides robustness tests. Finally, Section 6 concludes the paper.

[1] See Agrawal and Knoeber (1996) for a discussion of board structure and firm performance; and Mehran (1995) for a discussion of managerial stock ownership and firm performance.

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