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A strategic perspective of cross-listing by emerging market firms: Evidence from Indonesia, Mexico, Poland and South Africa☆

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ABSTRACT

This paper develops an approach to the analysis of cross-listing that brings together the financial and non-financial benefits of the phenomenon. We employ the real options framework, which offers a detailed characterisation of the strategic issues associated with cross-listing, in the context of internationalisation of emerging market firms. The associated hypotheses are tested using firm-level data from four large emerging market economies with different profiles in terms of institutional quality and financial development. This allows us to extend the existing literature by isolating the relative importance of institutional quality and financial development for the benefits of cross-listing.

1. Introduction

Why do firms decide to cross-list? The theoretical model posited by Chemmanur and Fulghieri (2006) shows that if there are two types of firms, one of which is more advanced and hence with lower information costs, and has to signal this, cross-listing can be an important signalling mechanism. It can reduce the importance of country-specific institutional quality at home (specifically, with respect to formal institutions such as investor protection) and enable firms to overcome limitations of country-level institutions by leveraging their firm-level governance quality (Doidge et al., 2007).[1] This has specific implications for firms based in emerging market economies that generally have both capital market imperfections and weak investor protection, and may be associated with adverse selection in developed and global capital markets (Herrmann et al., 2015).

The international finance approach to this question focuses narrowly on cost of capital advantages (Stulz, 1999), that may then be reflected in higher firm valuation (Karolyi, 1998). The limited engagement of the international business (IB) literature with the cross-listing phenomenon focuses on the advantages associated with "bonding" with institutions in a different context, especially where firms from relatively weak institutional contexts decide to cross-list in relatively strong institutional contexts (Peng et al.,

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[1] Unsurprisingly, in this literature, there is a lot of emphasis on the cross-listing of foreign firms on the US stock market, indicating the strong signalling effect associated with a US listing by non-US firms (see for example Alexander et al. (1988), and the literature which follows their work). Pagano et al. (2001), for example, find that European firms seek larger and more liquid markets, with better investor protection and institutional quality, and hence their attraction for cross-listing in the US.

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2009). To the best of our knowledge, there have been no attempts to incorporate the international finance and IB approaches to cross-listing by carefully distinguishing between the signalling and bonding attributes of the phenomenon.

We argue that the real options framework is able to anchor the motivation and ability of firms to attain and retain a cross-listing, and also facilitate a clear distinction between signalling and bonding. It is now well understood that the real options framework,[2] offers invaluable insights into how firms "design operational solutions to market frictions" (Mahoney and Qian, 2013; pp. 1024), where market frictions include factors such as informational opacity and institutional weakness. The first and main contribution of this paper, therefore, is to develop a strategic and integrated narrative concerning the motivations and ability to cross-list, and benefits associated with signalling and bonding by leveraging this framework.

This narrative provides the basis for our hypotheses which we test using firm level data from four emerging market economies that are large and economically important. Indonesia, Mexico and South Africa are part of the BRICS and MINT groups of countries, while Poland is a major former socialist economy at the heart of new Europe. These countries are representative geographically, and illustrative of the development paths of their region. At the same time, they offer significantly different dimensions of governance.

Our choice of countries also extends our analysis to encompass the literature on emerging market firms and the development of emerging market multinational enterprises (EMNEs), reflecting our second contribution. Initial work in this area explained the existence of EMNEs by "country specific advantages" (CSAs) such as economies of scale on account of large domestic markets (Ramamurti and Singh, 2009). More recently, it has been argued that in order to internationalise, emerging market firms may need complementary firm specific advantages (FSAs), in the form of higher profitability and internal financial resources (Bhaumik et al., 2010, 2015a,b). However, with very few exceptions (Stulz, 1999; Peng and Su, 2014), little has been said about the rationale for capital market based internationalisation *via* cross-listing, and how this form of internationalisation can help in turn the internationalisation of emerging market firms. We therefore explore how cross-listing can amplify the combinations of FSA and CSA available to emerging market firms.

Finally, the real options framework speaks to the well documented corporate governance challenges faced by emerging markets firms. In the face of certain institutional and financial voids, successful firms in emerging markets develop certain internal capital and labour market solutions that have adverse implications for governance quality within firms (Khanna and Palepu, 2000a; Young et al., 2008; Globerman et al., 2011). This has been recognised in the IB literature (Bhaumik et al., 2010), and our paper further integrates corporate governance of emerging market firms into the narrative concerning their internationalisation.

This paper proceeds as follows. First, we review the literature on cross-listing and derive our hypotheses using the real options framework. Next, we explain our multistage empirical research design and describe our data sample and variables. We then present our results. This is followed by a conclusion where we discuss the implications of our findings with regards to advancing the literature on cross-listing by emerging market firms and outline limitations of this paper which may offer avenues for future research.

2. Literature review on cross-listing

Much of the literature on cross-listing is focused on market reactions (Karolyi, 1998). It focuses on firms from various countries that seek to obtain cross-listing in New York, and generally finds a positive relationship between cross-listing and share prices, both in the short and long term (Lang et al., 2006; Roosenboom and Van Dijk, 2009; Miller, 1999). Capital market based globalisation can reduce the cost of capital because of greater ability of international investors to diversify away non-systematic risk (Stulz, 1999). Furthermore, cross-listing provides more information to the firm, in part generated through comment from external analysts (Herrmann et al., 2015), and in part through the market view to its opportunities (Foucault and Gehrig, 2008). This, in turn, enables them to make better investment decisions.

However, there is also a recognition about the signalling effects of cross-listing, and the benefits associated with the change in perception about a firm's corporate governance quality that cross-listing may trigger (Doidge et al., 2007; Abdallah and Goergen, 2008; Peng and Su, 2014). Specifically, if informationally opaque firms are generally not well governed then it becomes difficult for a single firm to prove that it is better governed than its competitors. This can result in adverse selection problems for investors (Akerlof, 1970), and consequently market failures that shut even relatively well governed firms out of the capital market. Signalling in this context is an act that can change the perception of the investors about the governance quality of the company, as they can distinguish between "good" and "bad" firms (Spence, 1973).

The more recent literature on cross-listing has extended the discussion about signalling – which is largely a response to problems of informational asymmetry or opacity – to encompass the related issue of institutional legitimacy. Bell et al. (2012) and Peng and Su (2014) argue that cross-listing may pave the way for greater legitimacy for emerging market firms, more by way of "reputation bonding based on informal institutions" than by way of the formal institutions. This perspective is consistent with the argument that a number of emerging market firms desire to "escape" weak institutions in their home country, and engage with more robust ones, in order to establish a credible risk–return trade off and potentially seek lower cost sources of finance (Cuervo-Cazurra and Ramamurti, 2014). It is also consistent with the analysis by Doidge et al. (2007) who argue that country level protection of investors is crucial to ambitious firms, and that of Coffee (2002) who argues that by cross-listing in

[2] Real options theory highlights the strategic aspects of taking managerial decisions under uncertainty (Dixit and Pindyck, 1994; Trigeorgis, 1996).

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