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Does the bonding effect matter in a more integrated capital market world?

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ABSTRACT

This paper examines the bonding effect of cross-listing before and after the stock market liberalization reforms in China. Consistent with the bonding hypothesis, we find that Chinese firms with foreign listings attain higher valuations than firms without foreign listings. We also find that they manage earnings less than comparable purely domestic-listed firms and have more informative stock prices. Further investigation indicates that the divergence in earnings quality between cross-listed and non–cross-listed firms shrinks dramatically after the Chinese stock market liberalization reforms in 2001 and 2002. Overall, the results suggest that the bonding effect is mitigated in an increasingly integrated capital market world.

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1. Introduction

In the international finance literature, conventional theories suggest that firms list overseas to lower their cost of capital through mitigated investment barriers, reduced risk exposure, enhanced liquidity, visibility, and investor base (e.g., Doukas and Switzer (2000), Foerster and Karolyi (1999), Lins et al. (2005), Miller (1999), Mittoo (1992)). While these hypotheses have had some success in explaining cross-listing practices, their empirical validity and saliency have been questioned recently.

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Major criticisms stem from their failure to explain why firms continue to list their shares overseas after the removal of investment barriers; why relatively few firms cross-list overseas given the proposed benefits; and why the market reacts more positively if the firm chooses to cross-list on major exchanges as opposed to over-the-counter (OTC) and private placements. Moreover, recent studies on the valuation gains of cross listing yield mixed results. For example, Sarkissian and Schill (2009) show that gains from foreign equity listings diminish over time while Doidge et al. (2009) report that they persist. Other studies show that foreign listing has different cost of capital implications. For example, Foerster and Karolyi (1999) report a 28% drop in the local beta of foreign firms listed in the U.S., while Errunza and Miller (2000) document that foreign firms listed in the U.S. experience an 11.4% decline in their cost of equity capital.

The limitations of conventional theories in explaining the cross-listing effect has led to the development of alternative hypotheses, among which the most frequently cited is the bonding hypothesis proposed by Coffee (1999, 2002) and Stulz (1999). In the context of this hypothesis, firms cross-list on more regulated markets to voluntarily bond themselves to higher regulatory, disclosure, and monitoring standards so as to mitigate potential agency conflicts (e.g., Coffee (1999, 2002), Reese and Weisbach (2002), Stulz (1999)). Consistent with the bonding story, Doidge et al. (2004) find that cross-listing on a more regulated market is an effective device in limiting controlling shareholders' expropriation of minority shareholders, and that foreign companies with shares cross-listed in the United States are worth more than similar home country firms. The major contribution of the bonding hypothesis is that it resolves a current paradox concerning why a majority of firms do not cross-list. According to Doidge et al. (2009a,b), a firm's decision to list overseas involves a trade-off between private control and bonding benefits. Cross-listing limits controlling shareholders' consumption of private benefits through both direct (e.g., more stringent disclosure and regulatory requirements) and indirect constraints (e.g., enhanced monitoring by sophisticated foreign investors). For a firm to cross-list, therefore, the benefits of bonding must be large enough to offset controlling shareholders' losses in private control.

Despite its strong theoretical appeal, the empirical evidence to date has been mixed. The literature is permeated with both supportive (e.g., Doidge et al. (2004), Doidge et al. (2009a,b), Reese and Weisbach (2002)) and conflicting findings (e.g., Gozzi et al. (2008), Lang et al. (2006), Siegel (2005)). For instance, based on the evidence that the Tobin's Q ratio falls sharply after firms' foreign listings, Gozzi et al. (2008) conclude that international listings are more consistent with the prediction of the segmentation theory rather than that of bonding hypothesis. The logic behind their argument is that if firms list overseas to bond themselves to a better corporate governance system, then cross-listing should produce an enduring rather than a transitory effect on firm valuation. This argument, however, ignores the fact that the evolution of global markets *per se* might have a significant impact on the effectiveness of the bonding strategy. Since a necessary condition for the bonding hypothesis to sustain itself is the divergence of underlying regulatory, disclosure, and monitoring standards across markets, one important question that emerges is whether the bonding effect persists under conditions of greater financial integration across capital markets. That is, if greater integration across capital markets translates into greater synchronization of regulatory, disclosure, and monitoring standards, then the bonding effect is expected to weaken. If, however, greater integration is not accompanied by harmonization of regulatory environments across markets, then the bonding effect is expected to persist. Therefore, to the extent that the degree of economic integration may influence the regulatory wedge across markets, examination of the cross-listing effect under conditions of increasing market integration allows us to shed new light on the bonding effect. This paper effectively addresses this issue by testing the long-term effects of cross-listing on earnings quality, stock price informativeness, and firm valuation, controlling for the degree of market integration.

Besides the everlasting debate over conventional versus bonding theories, another crucial challenge facing the bonding hypothesis is the signaling hypothesis. As Cantale (1996) and Moel (1999) point out, even though cross-listing has a positive impact on firm value, the observed listing benefits may not necessarily be attributable to the bonding role of cross-listing; rather, it may simply be a reflection of the signaling effect. By cross-listing on a market with more stringent disclosure and regulatory requirements, a firm can signal to the market that it is a high-quality firm, resulting in a higher valuation, even though no significant improvement in its corporate governance is made. Consistent with the signaling hypothesis, Siegel (2005) finds that U.S. listing is not a perfect substitute for a strong legal

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