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Cross-listing effect on information environment of foreign firms: ADR type and country characteristics

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ABSTRACT

We examine sources of improvement in the information environment of foreign firms that cross-listed in the United States as American Depositary Receipts (ADRs) between 1995 and 2005. We analyze changes in the number and dispersion of analyst recommendations on foreign firms following their cross-listing. We find increases in analyst coverage intensity across all four types of ADR programs, especially among firms that were listed on organized exchanges (the listing effect), and those that adopted capital raising ADR programs (the financing effect). Our results suggest that the listing effect is more persistent than the financing effect. On the other hand, reductions in recommendation dispersion are observed mainly for firms that choose non-capital raising ADRs and those from emerging markets. Overall, improvements in information environment are more profound among foreign firms originating from countries with greater information asymmetry, namely, countries with weaker legal tradition and rule of law, and countries that are less familiar to U.S. investors.

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1. Introduction

Recent evidence suggests that cross-listing in the U.S. improves the information environment of foreign firms.[1] In this paper, we examine the sources of improvement in the information environ-

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[1] Lang et al. (2003) report greater analyst coverage and increased forecast accuracy for foreign firms following their cross-listing in the U.S. Baker et al. (2002) show an increase in the visibility of foreign firms after their listing on major international stock exchanges such as New York Stock Exchange (NYSE) or London Stock Exchange (LSE).

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ment by analyzing changes in the number and dispersion of analyst recommendations of foreign firms before and after their cross-listing in the U.S. In particular, we examine cross-listing venues and home country characteristics of foreign firms to determine the roles of increased information disclosure, increased legal exposure, and other factors in explaining the improvement in information environment.

Foreign firms may cross-list in the U.S. to improve information disclosure. Cantale (1996), Fuerst (1998) and Moel (1999) argue that firms cross-list on exchanges with stricter disclosure requirements to reduce information asymmetry, and signal their quality to investors that distinguishes themselves from low quality rivals. Chemmanur and Fulghieri (2006) show that firms benefit from listing on exchanges with high disclosure standards only if information about them can be produced at low cost. Thus, firms cross-list when they intend to expand their base of low cost information producers overseas, or to take advantage of the greater transparency of overseas exchanges.[2] Through cross-listing on organized exchanges, foreign firms might also "bond" with U.S. laws and regulations. The additional scrutiny discourages managers of cross-listing firms from excessive private control (Coffee, 1999, 2002; Stulz, 1999), and hence provides greater protection to minority shareholders (Fuerst, 1998; La Porta et al., 1997, 1998, 2000; Reese and Weisbach, 2002). The increased disclosure requirements and legal liabilities of cross-listed firms could be the sources of improvement in their information environment.

We examine how analyst coverage changes when foreign firms cross-list their shares in the U.S. as American Depositary Receipts (ADRs). Boubakri et al. (2010) show that the choice of ADR programs adopted by foreign firms is driven by their plans for raising capital and their home market characteristics. Their findings indicate that cross-listing benefits may take the form of a listing effect, i.e., listing on an organized exchange, and/or a financing effect, i.e., capital raising along with cross-listing. In order to gain a comprehensive understanding of the possible sources of cross-listing benefits on the information environment of foreign firms, unlike Lang et al. (2003) and Baker et al. (2002), we include both exchange listed ADRs (Levels II and III ADRs) and non-exchange listed ADRs (Level I and Rule 144A ADRs) in our analysis. The inclusion of all ADR types also allows us to examine the financing effect as capital raising activities accompany Level III and Rule 144A ADRs. Our final sample includes 713 seasoned foreign firms that cross-listed in the U.S. between 1995 and 2005.

We document increases in the number of analyst recommendations on foreign firms after their cross-listing in the U.S. across all four types of ADR programs. The increase is statistically significant for exchange listed ADRs, which subject foreign firms to a higher level of disclosure requirements and legal exposure. In addition, the increase in analyst coverage intensity is more profound among foreign firms from emerging markets than those from developed markets. These findings are consistent with the information disclosure and bonding explanations, and the listing effect of cross-listing benefits on the information environment of foreign firms.

The improvement in visibility for foreign firms adopting non-exchange listed programs, i.e., Level I or Rule 144A ADR, however, is consistent with Leuz's (2003) argument that firms benefit from the mere act of cross-listing. It also supports the prediction of Peress (2010) that the information environment of a firm changes with an increase in its investor base. Furthermore, we document that incumbent shareholders collectively acquire less information following an expansion in the investor base. This is evidenced across all four ADR samples, as there is a substantial percentage, ranging between 29% and 39%, of incumbent brokers dropping their coverage on foreign firms after their cross-listing. However, the drop in the coverage of incumbent analysts is outweighed by the coverage initiation of new analysts, thus resulting in an overall increase in analyst coverage of cross-listing firms. Echoing Boubakri et al. (2010), our further results show a financing effect of cross-listing benefits on the information

[2] Besides, the traditional explanation suggests that foreign firms cross-listing in the U.S. benefit from overcoming investment barriers, which improves the liquidity of their shares and hence lowers their cost of capital, via gaining access to the world's largest capital market (Foerster and Karolyi, 1999; Errunza and Miller, 2000; Lins et al., 2005; Eaton et al., 2007). The growth opportunities hypothesis posits that cross-listing firms benefit from their abilities to take advantage of growth opportunities, since the U.S. listing improves the protection of minority shareholders by reducing the extent of expropriation by controlling shareholders, which makes it easier for cross-listing firms to raise external capital (Doidge et al., 2004).

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