J. of Multi. Fin. Manag. 22 (2012) 131–150

Contents lists available at SciVerse ScienceDirect

Journal of Multinational Financial Management

journal homepage: www.elsevier.com/locate/econbase

The determinants and consequences of IPOs in a regulated economy: Evidence from China☆

Junxiong Fang, Haina Shi*, Haoping Xu

School of Management, Fudan University, Shanghai 200433, China

ARTICLE INFO

Article history:
Received 30 May 2011
Accepted 22 June 2012
Available online 5 July 2012

Keywords:
Government regulation
IPO
Issuing size
Market return

JEL classification:
P34
G18
N2

ABSTRACT

Using a sample of 156 monthly returns over the period of 1996–2008, we find a positive relation between the monthly issuing size and prior market returns, suggesting that the government decides the timing and the size of issuances based on prior market conditions. Different from previous findings, our study finds no evidence of decline in subsequent market returns after initial public offerings (IPOs). However, IPO issuance has a significantly negative impact on the return momentum effect, whereas the degree of impact is indifferent to the issuing size. We conclude that the overall mild impact on the subsequent market results from the government's regulation of the IPO market.

1. Introduction

The decision to go public is one of the most important issues in corporate finance (Pagano et al., 1998). Many studies have examined the determinants of firms' decisions to go public and the

☆ We are grateful for the useful comments from Chao Chen, Jeong-Bon Kim, Changjiang Lv, Jay Ritter, Charles Shi, Kun Wang, and Steven Wei. We also thank workshop participants from Fudan University, The 2011 Global Finance Conference. All errors are our own. Fang acknowledges financial support from the National Nature Science Foundation of China (No. 71072003) and the Humanities and Social Science Research Project of the Ministry of Education in China (No. 08JC790019). Shi acknowledges financial support from the Humanities and Social Science Research Project of the Ministry of Education in China (No. 12YJC630169). Xu is grateful for the financial support of the National Nature Science Foundation of China (No. 70802017) and the Shanghai Fund of Philosophy and Social Science (No. 2010BJB012).

* Corresponding author. Tel.: +86 21 2501 1122; fax: +86 21 6564 3203.
E-mail addresses: jxfang@fudan.edu.cn (J. Fang), Haina@fudan.edu.cn (H. Shi), haopingxu@fudan.edu.cn (H. Xu).

1042-444X/$ – see front matter
http://dx.doi.org/10.1016/j.mulfin.2012.06.002

consequences of initial public offerings (IPOs). These studies find that firms tend to issue equity when stock prices are high (Graham and Harvey, 2001; Schultz, 2003; Kim and Weisbach, 2008) or during booming periods (Choe et al., 1993), suggesting that firms use 'windows of opportunity' to reduce the costs of raising capital. However, as a result of increasing supplies of stocks with unchanged demand, the issuance of new stocks usually leads to an overall decrease in market returns. The negative impact of new stock issuances on market returns is evidenced in the U.S. (Baker and Wurgler, 2000), in emerging markets (Braun and Larrain, 2009), and internationally (Henderson et al., 2006; Wang, 2011). Although Wang (2011) includes China in the sample, we note that the evidence above is contingent on the free capital markets assumption:firms can freely choose the time of issuance. However, the Chinese capital market presents a different situation: the timing and sequences of IPOs are largely regulated by the China Securities and Regulatory Commission (CSRC).[1] As discussed in Section 2.2, regulation has been repeatedly adopted by the CSRC since the establishment of China's capital market. Therefore, such regulation is an important issue for the development of China's capital market and is potentially meaningful to capital market regulators around the world. Most existing literature on regulation examines the economic consequences of a particular regulation, such as Sarbanes–Oxley Act (Zhang, 2007), the Securities Act of 1934 (Benston, 1973), and the 1964 Securities Acts Amendments (Greenstone et al., 2006). Leuz and Wysocki (2008) review the studies on disclosure regulations and note that extant theories of disclosure regulations are mostly static and concern questions of whether and how to regulate. Thus, the authors propose more work on the dynamics of regulation. The regulation studied in this paper is dynamic given that it is repeatedly employed by the CSRC. Thus, we are motivated to utilize this regulation's uniqueness to examine the effect of a regulation that occurs in different stages in the history of capital market developments. Although government intervention in the capital market is a common phenomenon in China, it is rare in developed markets such as the U.S. However, the experiences of recent scandals and the financial crisis provide some evidence that appropriate government intervention is potentially beneficial to capital markets to some extent. Therefore, we are motivated to study the role of government intervention in capital markets, particularly in the setting of IPO markets. The unique feature of government intervention in the Chinese IPO market provides a good opportunity to conduct the study.

Using a sample of 156 monthly market returns in China's A-share market from 1996 to 2008, we draw an overall conclusion that the CSRC can balance its objectives of promoting equity financing and preventing post-IPO market decline through deliberate regulation of the time and size of IPO issuances. We document that the monthly issuing size of the whole market is positively related to prior IPO market returns. With respect to the effect of regulation, we find no evidence of subsequent market return declines, i.e., the 6-month cumulative return (*CR*) after the IPO month is not significantly different from that of the no-IPO month (the benchmark). However, IPO issuance has a significantly negative impact on the return momentum effect. Further testing shows that the impact is indifferent to the issuing size. We conclude that the results are at least partly due to the CSRC's cautious management of the timing of large IPO issuances to reduce the financing costs of issuers and to mitigate the negative impact on the stock market. Our results suggest that for transitional markets such as China, government intervention in the capital market at least partially improves market efficiency. The findings might shed light on other transitional and emerging economies.

We contribute to the literature in the following ways: First, we contribute to the economic literature on the efficiency of regulation in general. The role of regulation in capital markets is disputable in the economic literature. Reviewing the related literature on disclosure regulation, Leuz and Wysocki (2008) suggest that the net effect of disclosure regulation on a market or an economy is largely an empirical question. The 'public interest theory' holds the view that a capital market

[1] The CSRC is a ministry-level unit directly under the State Council and regulates China's securities and futures markets with an aim to ensure their orderly and legitimate operation. The CSRC is authorized to implement a centralized and unified regulation of the nationwide securities market to ensure their lawful operation. The CSRC oversees China's nationwide centralized securities supervisory system with the power to regulate and supervise securities issuers and to investigate and impose penalties for illegal activities related to securities and futures. The CSRC is empowered to issue Opinions or Guideline Opinions, non-legally binding guidance for publicly traded corporations. The CSRC's functions are similar to that of the Securities and Exchange Commission in the U.S. (see http://en.wikipedia.org and http://www.csrc.gov.cn/pub/csrc_en for a detailed description of the CSRC).