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Cross-listing performance and insider ownership: The experience of U.S. investors[☆]

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ABSTRACT

Insider-owned firms pursue U.S. cross-listings following periods of extraordinary performance. However, the long-run post-cross-listing abnormal returns become negative only for insider-controlled cross-listings. We find that the Sarbanes–Oxley Act (SOX) has mitigated the market-timing attempts as negative abnormal returns are limited to the pre-SOX period, supporting a cross-listing bonding benefit after U.S. securities regulation was enhanced. In addition, investors anticipate future operating performance as stock returns incorporate forthcoming operating outcomes one and two years ahead. Whereas capital-raising cross-listings show better operating performance than non-capital-raising, the returns of capital-raising firms are more sensitive to the potential agency problems created by insider-ownership.

1. Introduction

During the last two decades, firms from emerging markets have experienced a substantial reduction on restrictions to capital flows and therefore have enjoyed access to more mature capital markets. Cross-listing abroad represents the most common way to enter foreign equity markets. In particular, U.S. exchanges have been popular destinations among emerging-

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market firms looking to cross-list shares overseas.[1] When firms pursue a U.S. dual-listing, they deposit a fraction of their shares in an investment bank located in the host country, which subsequently issues American Depository Receipts (ADR) in exchange for these shares.[2] Existing literature suggests that firms cross-listing in the U.S. benefit as market integration, liquidity, investor recognition, shareholder base, information environment, and shareholder protection improve.[3] However, whether shareholders have a long-term benefit following cross-listing events is still inconclusive.

There is consensus among academics that after firms cross-list in the U.S., there are short-term positive abnormal returns. This finding appears intuitive as the expected reduction in the cost of capital has a one-time short-term adjustment to market valuation, but potentially leads to lower long-run expected returns. Formerly negative net present value projects become wealth-increasing investment opportunities as the discount rate declines in the new phase of the cross-listed firm**.** Similarly, the perceived shift in transparency and shareholder protection impact firm valuation through the expected cash flows (numerator) component of the valuation equation. There is a strong intuition behind the commonly established short-term gains that follow cross-listings. Yet, to what extent investors have benefitted from long-term holding of equity of cross-listed firms remains unclear. This paper examines the long-term operating and stock performance of emerging-market firms after they cross-list in the U.S.

We contribute to the existing literature by analyzing the implications of ownership structure, a proxy for potential agency problems, on the post-cross-listing performance. Ownership structure is of particular relevance in emerging markets as it affects corporate governance and determines the degree of potential issues between principal and agents (Claessens and Yurtoglu, 2013). Specifically, when firms are insider-controlled, the potential for agency problems is higher than in non-insider-controlled firms (La Porta et al., 1999; Li et al., 2004). This is particularly important in the context of real or perceived deficiencies in legal protection afforded to investors in developing countries. The effect of ownership structure on firm performance has received some attention in previous literature; however, its effects on the long-term operating performance and stock returns of cross-listed firms have not been previously documented. This issue is relevant as firms that cross-list in the U.S. have considerable influence on their home countries' economy and on the world's financial markets. We provide strong arguments in support of policies aimed at increasing the accountability of foreign corporate executives with the intention of protecting U.S. stock-market participants. In addition, it is important for academics and practitioners to identify whether firms benefit from cross-listing on U.S. stock exchanges and whether firm-level shareholder protection exerts any influence on the outcome.

There is a gap in the cross-listing literature as previous research does not employ firm-level measures of corporate governance to assess the operating performance and stock returns around cross-listing events. The increase in shareholder protection implied by the bonding hypothesis has received considerable attention in recent years. Using cross-listing events, we test the bonding hypothesis (performance improves) versus the "avoiding" or market timing hypothesis (performance deteriorates) put forward by Licht (2003), controlling for the degree of potential for agency conflicts. Lastly, we test whether the Sarbanes–Oxley Act (SOX) has affected the performance of cross-listed firms given that exchange-traded ADRs are subject to this law.[4] Our manuscript contributes to the existing literature as, to the best of our knowledge, there is no prior empirical evidence on the effects of firm-level investor protection on the long-term operating performance and stock returns of emerging-market cross-listed firms.

Our findings lend support for the market timing hypothesis prior to the enactment of the SOX. Insider-owned firms cross-list following periods of extraordinary positive performance as they outperform a benchmark only in the pre-cross-listing years. In addition, the long-run abnormal returns in the post-cross-listing period are negative only for firms controlled by insiders. However, SOX has mitigated the attempts to time the cross-listing market as negative abnormal returns appear only during the pre-SOX period, questioning the soundness of the bonding hypothesis prior to this piece of legislation. Moreover, consistent with the equity offerings literature, the stock returns of capital-raising cross-listings are more sensitive to the risk of being expropriated by insiders.

2. Related literature and hypotheses

2.1. Background on cross-listings

Firms cross-listing in the U.S. reduce their cost of capital as market integration and risk sharing improves (Stapleton and Subrahmanyam, 1977; Errunza and Losq, 1985; Alexander et al., 1988). In addition, cross-listed firms improve their liquidity (Karolyi, 1998; Foerster and Karolyi, 2000), investor recognition and shareholder base (Foerster and Karolyi, 1999),

[1] Exchange-listed sponsored ADRs increased from 79 (three from emerging countries) by December, 1990 to 366 (215 from emerging countries) by December, 2010. The sources are the depository receipts websites: http://www.adrbnymellon.com, http://www.citiadr.idmanagedsolutions.com/ and https://www.adr.com.

[2] There are four types of ADRs. Level 1 trade only over-the-counter (OTC). Level 2 and Level 3 are U.S. exchange-listed; however, the latter is allowed to raise new capital. Level 4 or Rule 144-A are ADR private offerings exclusive to qualified institutional buyers. Throughout the paper we refer to levels 2 and 3 as exchange-traded cross-listings.

[3] Karolyi (2006) and King and Segal (2009), among others, identify comparable benefits as the main reasons why firms cross-list in the U.S.

[4] The U.S. Congress passed the Sarbanes–Oxley Act in July 2002, following a number of high-profile corporate scandals during 2001. This Act aims to prevent managerial and accounting misconduct by imposing additional disclosure requirements and corporate governance mandates.