



# Impact of legal institutions on IPO survival: A global perspective



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## ABSTRACT

Around the world, investors, practitioners, regulators and policy makers seek to understand whether, when and why recently listed stocks, initial public offerings (IPOs) are delisted rather than continue trading (survive). Using data on 7,627 IPOs issued during 2000–2008 across 32 countries, we explore the impact of the legal system on IPO survival. We find that IPOs in countries with better investor protections remain listed for longer. This suggests that better legal systems increase the net benefits companies derive from staying listed. We also provide evidence that better legal systems increase the effectiveness of IPO certification by venture capitalists, underwriters and auditors.

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## 1. Introduction

Around the world, investors, practitioners, regulators and policy makers seek to understand whether, when and why recently listed stocks are delisted. Yet, little is known to date on how delisting varies across countries and regions. This paper examines the impact of the legal system on delistings of initial public offerings (IPOs) across 32 countries around the world. Following the law and finance literature (e.g., LaPorta et al., 1997, 1998, 2006; Berkowitz et al., 2003) we focus on quality of the legal system as measured by the efficiency of the judicial system, the rule of law, the absence of corruption, the risk of expropriation and of contract repudiation, and the extent of shareholder rights. The law and finance literature (Shleifer and Wolfenzon, 2002) shows that a country's legal system affects whether companies go public. We argue that legal systems also determine whether companies stay public, and hence whether their stocks remain listed. Legal systems that protect minority shareholders and investors increase the effectiveness of contracts, reduce the (informational and agency)

costs of external financing and improve company performance (e.g., LaPorta et al., 2006; Berkowitz et al., 2003). It is reasonable to expect that this reduces the chances of delisting due to poor performance. By reducing the cost of external finance, better legal systems also increase the benefits to company insiders of being listed net of listing costs (Shleifer and Wolfenzon, 2002). Hence, we may expect that companies are less likely to opt for voluntary delisting in better legal systems. On the other hand, by facilitating creditor recourse, more efficient legal systems may speed up the delisting and liquidation of poorly performing companies.<sup>1</sup> The direction of the impact of the legal system on IPO survival is ultimately an empirical issue which our analysis aims to resolve.

Either explicitly through (de-)listing rules or implicitly through established practice, IPO markets require the certification of issues by repeated players in financial markets with reputational capital, including underwriters, venture capitalists (VCs), and auditors (Carter and Manaster, 1990; Megginson and Weiss, 1991). Certification helps resolve asymmetric information and agency problems

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<sup>1</sup> Unlike the large Financial Institutions with a 'Too big to fail' resolution, IPO firms face a relatively higher risk of bankruptcy and failure (see detailed discussions of Too big to fail resolutions in Kaufman, 2014).

between issuers and investors through explicit and implicit contracts. For control and monitoring mechanisms such as certification to be effective, requires a legal system that effectively enforces contracts and enables monitors to impact the actions of company insiders and obtain redress from them (Doidge et al., 2013). As a result, we may expect that certification by financial and other backers is likely to be strengthened by more efficient legal systems. Conversely, certification by reputable underwriters and other 'certifiers' relies on intermediaries' reputations to enforce implicit contracts rather than the enforcement of explicit contracts by the legal system. It may be an alternative (*i.e.*, a substitute rather than a complement) to explicit contracting if it involves the use of non-verifiable information that is privately observed by the certifying intermediary. However, the threat of litigation by disgruntled investors also reinforces underwriters' incentives to avoid losing valuable reputation. *A priori*, legality may be either a substitute or a complement for certification, and our analysis aims to resolve this issue empirically.

Almost all prior research on IPO survival focuses on individual countries, in most cases on the U.S. (*e.g.*, Hensler et al., 1997; Jain and Kini, 1999, 2000).<sup>2</sup> Some studies examine IPOs in the UK (Espenlaub et al., 2012).<sup>3</sup> Vismara et al. (2012) provided evidence on survival across several European countries. The quality of the legal system could have a significant impact on IPO survivals or failures. Previous studies on country's legal condition find that cross-country differences in the legal framework affect corporate governance (LaPorta et al., 1998; Mitton, 2002) and corporate valuation (LaPorta et al., 2002). However, these studies do not investigate whether the survival profiles of the IPOs varies with the level of legal system across countries. The survival of the IPO firms has implication for various stakeholders as outlined in Section 2. To date not much is known whether the quality of the legal system has a positive/negative effect on IPO survival. Single-country (or single-region) studies do not shed light on the impact of the legal system on IPO survival due to minimum variations of the legal conditions variables within a country. Our study contributes to the literature by investigating this impact using a sample of 7627 IPOs issued during 2000–2008 across 32 countries. The results of our analysis show that better legal systems help IPOs remain listed longer. We show that the quality of the legal system improves IPO survival directly (*e.g.*, by reducing the contracting costs faced by listed firms), and also indirectly by increasing the positive impact on IPO survival of IPO certification by venture-capital backers, underwriters and auditors.

Our study also examines the impact of market conditions on IPO survival. As market conditions vary both across countries and over time, our cross-country analysis of market conditions extends single-country analyses of the impact of (time-series variations in) market conditions on IPO survival. Our analysis controls for a wide range of firm- and issue-specific variables that have been shown to impact IPO survival in single-country setting, and our findings are robust to a range of variations in research design.

Our results are of interest to stock markets, regulators and policy makers worldwide interested in promoting stock-market listings and improving the availability of external equity to companies.<sup>4</sup> Our results are also of interest to investors seeking to identify stocks

suitable for long-term investments, particularly to investors planning to commit capital outside their home market.

The remainder of this paper is organised as follows. Section 2 motivates and outlines our research questions in the context of the conceptual framework and relevant literature. Section 3 discusses our sample and methodology. Section 4 reports our empirical results, and Section 5 concludes the paper.

## 2. Conceptual framework and literature

### 2.1. Legality and IPO survival

The 'survival' of IPOs, that is, the continued trading of newly listed stocks on the stock market, matters not just to companies, their investors and stakeholders, but more widely to practitioners, policy maker, regulators and even to stock markets themselves. Survival is typically a consequence of good firm performance. As a result, it has been proposed as a proxy for firm performance (*e.g.*, Audretsch and Lehmann, 2005; Espenlaub et al., 2012) and complements return-based measures of post-IPO performance that are often difficult to quantify, suggesting that an appropriate measure of performance for IPO firms is their ability to survive over time (Gerakos et al., 2013). Companies, investors and policymakers are interested in IPO survival because as long as a stock remains listed, the issuing company can raise external funding from public markets. This has implications for its cost of external capital and real investment decisions, which in turn benefit other stakeholders including employees. Legal system that are more effective in reducing the information and agency costs of external equity increase company value (performance) and the net benefits of being listed.

Shleifer and Wolfenzon (2002) show theoretically how the legal system of a country affects the costs and benefits that founder-owners derive from going public. Controlling shareholders of IPO companies are less likely to extract private benefits from minority shareholders in countries with more efficient judicial systems that are characterized by the rule of law, stronger shareholder rights, and where there is less chance of corruption, expropriation and contract repudiation. By reducing the private benefits of controlling shareholders who can extract at the expense of minority shareholders, better legal systems increase the value of IPOs to investors. For a given listing cost, more effective legal systems increase the net benefits founder-owners derive from listing their companies. Doidge et al. (2013) find empirical support for the prediction that more effective legal institutions increase IPO activity both in terms of numbers and proceeds of IPOs. Their study builds on the previous law and finance literature that demonstrates the impact of legal institutions on IPO activity and on economic and financial development more generally (LaPorta et al., 1997, 1998, 2006; Berkowitz et al., 2003). LaPorta et al. (1997, 1998) find that countries with stronger investor ('anti-director') rights and tighter securities laws have higher numbers of IPOs per capita. Djankov et al. (2008) finds that the ratio of equity issued in IPOs (relative to GDP) is positively correlated with how effectively legal systems restrict insiders' 'self-dealing' transactions. The law and finance literature based on LaPorta et al. (1997, 1998) also shows that legal institutions and rules influence other corporate decisions (capital structure, payout policy, VC contracting and corporate behaviour) and financial performance (Berkowitz et al., 2003; Cumming et al., 2006; Cumming et al., 2010).

In sum, the existing literature shows that the legal system increases the likelihood that firms choose to go public. However, the impact of the legal system on how long companies stay listed remains unexplored. Following the reasoning of Shleifer and Wolfenzon (2002), it is reasonable to expect that, once listed, companies continue to derive higher net benefits of remaining

<sup>2</sup> Studies of IPO survival in the U.S. include Fama and French (2004), Jain and Kini (1999, 2000), Jain and Martin (2005), and Jain et al. (2008).

<sup>3</sup> The literature on individual countries is limited but growing; see Baschieri et al. (2015) on Italy, Carpentier and Suret (2011) for Canada, Cressy and Farag (2014) for Hong Kong, Liu and Li (2014) for China and Gopalan and Gromley (2013) and Wadhwa et al. (2016) for India.

<sup>4</sup> Stock market investors are also concerned with the Seasoned Equity Offerings (SEOs) and announcement of large capital infusions like government bailout and private equity placement (Elyasiani et al., 2014).

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