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European Sovereign Debt Crisis and the performance of Dutch IPOs☆

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ABSTRACT

We provide new evidence of the impact of the ongoing deep financial crisis on the performance of Dutch IPOs during the period from January 1990 to May 2012. The findings indicate an increasing level of underpricing as a result of the recent financial crunch. This situation is attributed to the aggressive efforts of underwriters to create demand as well as their strong focus on rewarding investors for their participation. Their actions build the soil for long-term underperformance, a conclusion supported by multiple studies in the literature. Pre-owner loyalty signals the IPOs' quality and promotes compensation by less underpricing. Going public with the aid of a reputable underwriter does not pay off, as it does not reduce the amount of money left on the table. Consistent with the information revelation theory, we argue that the underpricing phenomenon can be largely explained by a general desire for listing.

1. Introduction

The recent global financial crisis, the worst since the Great Depression, owes its birth to the United States housing bubble and its perpetual nature to the European Sovereign Debt Crisis (ESDC), which has made it impossible for some countries in the euro-zone to repay or refinance their government debts without the assistance of third parties. The inability of these euro countries to service their debt-scared depositors, caused in part by mass savings being withdrawn from accounts, has led to serious problems in the banking system. Banks no longer possess the financial strength which they used to have in the past to lend funds to firms and sponsor investment projects. As a result, companies are faced with a new reality, as they can no longer borrow capital from the banks. Therefore, those with a great need for cash have been considering listing in stock markets, but the situation in this sector has changed as well, as the cost of equity has increased to compensate for the investors' risk.

Overall, the number of initial public offerings (IPOs) worldwide has precipitously dropped after the technology stock bubble burst in 2000 and collapsed to new lows during the (ESDC) of 2008 and its aftermath. The low number of IPOs over the last decade has generated much discussion among private company executives, exchange officials, policy makers, and the financial press, as well as among venture capitalists and buyout firms that depend on an active IPO market for their existence. However, so far this issue has not received a great deal of academic attention (Gao, Ritter, & Zhu, 2012). Ritter (2011) recently suggested that much of the decline may be due to a structural shift that has lessened the profitability of small independent companies relative to that of larger, more established organizations that are better capable of realizing economies of scope.

There is extensive evidence of underpricing (e.g., Loughran, Ritter, & Rydqvist, 1995; Lee, Taylor, Yee, & Yee, 1996; Jenkinson, Morrison, & Wilhelm, 2005; Gajewski & Gresse, 2006; Tian & Megginson, 2007 Chambers & Dimson, 2009; Ritter, 2009; Cai, Lee, & Valero, 2010; Thomadakis, Gounopoulos, & Nounis, 2012; Gounopoulos & Hoebelt, 2013;) and there are convincing international indications of long-term underperformance.[1] Generally, the poor results of newly listed public companies as reflected by returns lower than the market benchmarks, become visible only after a longer-term period. Studies in numerous countries have confirmed underperformance after one (Aggarwal &

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[1] Vismara, Paleari, and Ritter (2012) find that the average long-run performance of initial public offerings (IPOs) on second markets is dramatically worse than for main market IPOs.

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Rivoli, 1990; Lee et al., 1996; Chan, Wang, & Wei, 2004),[2] to three (Ritter, 1991; Lee et al., 1996; Chan et al., 2004; Merikas, Gounopoulos, & Nounis, 2009) or five years (Loughran & Ritter, 1995). Following the so-called fads theory, Aggarwal and Rivoli (1990) attribute underperformance to a temporary overvaluation of the IPO firm at the offering date. After a while, this over-optimism disappears, after which the value of the new share is downwardly adjusted. Ritter (1991) has further advanced the fads theory by showing that IPO firms with a high-risk profile (i.e., younger, smaller, and active in vulnerable sectors) are more easily subject to shareholder sentiments, the so-called fads of the stock market. Further exploring the shareholder sentiment concept, Cornelli, Goldreich, and Ljungqvist (2006) reveal that high gray market prices (indicating over-optimism) are a very good predictor of first-day aftermarket prices, whereas low gray market prices (indicating excessive pessimism) are not. This asymmetry occurs because larger (institutional) investors can choose between keeping the shares allocated to the IPO or reselling them when small investors are overoptimistic.

Our research addresses a number of important questions related to the performance of IPOs in the context of the (ESDC). It contributes to the academic body of literature by providing evidence of the effect of this crisis and its aftermath on the performance of Dutch IPOs. We start with the following main question: Has the recent financial crisis affected the listings and the level of underpricing? If yes, to what extent? Has the long-term performance of Dutch IPOs increased following the recent financial crisis? How do the various benchmarks affect the long-term performance in the Netherlands? What are the determinants that affect short- and long-term performance?

Part of the period covered in our comparative study concerns the Internet bubble, which induced a large number of growth firms to go public, resulting in a hot issue market from 1997 to 2000.[3] As regards this time, the IPO literature particularly focuses on the phenomenon of "hot issue markets," i.e., periods characterized by a large number of offerings and a high average underpricing (Ritter, 1984a,b; Derrien, 2005; Ljungqvist, Nanda, & Singh, 2006; Derrien & Kecskes, 2007). However, obviously for time-motivated reasons, the literature has not yet elaborately explored the ESDC, an event which has driven the entire globe into a deep recession. This situation reminds us that we are now in what we can describe as an ultimate "cold issue market."

Throughout the hot and cold periods, the level of IPO underpricing may fluctuate, depending on the moment when a firm chooses to go public. These alterations require businesses to have easy access to capital funds in the markets. Traditionally, periods of crisis have been associated with uncertainty and information asymmetry. In the uncertain economic environments resulting from these circumstances, venture capitalists and investors are reluctant to invest their money in financial markets unless there is some guarantee of obtaining attractive rewards for the risk they bear. Companies which decide to raise equity during a financial crisis should be willing to accept the consequences of the cold market, i.e. changes in the level of underpricing. This issue highlights the objective of this research, which is focused on identifying and explaining the phenomenon of (cold) crisis in the context of the Dutch stock market.

During the study period covered, many changes took place in the international arena that affected the Dutch market. The most important one and the central theme of our study, is the ESDC, the depth of which is comparable with that of the crisis of 1929. Furthermore, also of considerable importance is the fact that quite recently two more crises occurred: the 2000 Internet bubble crisis, which affected both the stock market and the number of listings, and European Sovereign Debt Crisis, which is an extension of the 2007 subprime mortgage. These events raised questions regarding bank solvency and damaged investor confidence and even further impacted the global stock markets, which suffered large losses during late 2007 and early 2008.

Our aim is to map out the Dutch market's response to the ESDC and the levels of shareholder returns, based on various benchmarks. As regards this issue, Dimson and Marsh (1986) and Fama and French (1996b) provide considerable evidence that benchmark selection can have an important impact on the scale of the abnormal returns. We compare the abnormal returns among a number of alternative benchmarks. In addition, we compute the abnormal returns up to three years after the offering. In our study we employ three models: the basic Capital Asset Pricing Model (CAPM), the Fama and French (1996a,b) three-factor model, and the Carhart (1997) FF3F-type model, extended for the occasion of this research.

We employ a sample of 144 Dutch IPOs listed over the period Jan 1990–May 2012. The findings indicate an increasing level of Dutch IPO underpricing as a result of the ESDC. During the ESDC the short-term returns to the investors actually increased, as these investors were rewarded for the risk of participating in IPOs during a highly uncertain financial period. In the long term, however, IPOs in the Netherlands appear to underperform, yielding negative abnormal returns. With respect to the factors that determine the long-run performance of IPOs, we see in line with our predictions — a positive and significant relationship between the size of the firm and the returns to the investors in the three-year long-term period of our study. This result suggests that large firms perform better and are safer to invest in, in the long term. We also observe a positive relationship between market condition (hot/cold) and returns in the long aftermarket. This relationship holds strong irrespective of the period (one, two, or three years) of study. Finally, in contrast to our expectations, non-reputable underwriters are associated with better returns in the very long term (up to 36 months).

Our study makes several contributions to the IPO literature. First, the paper is based on a unique, up-to-date database and provides new evidence of investor returns from IPOs as an alternative investment option in the face of the European Sovereign Debt Crisis. Second, it maps out the characteristics of companies that decide to list in an extreme financial environment. Third, it is the first Dutch study to explore long-term returns using the Fama and French (1996a,b) (extended) value-weighted three-factor model. Fourth, it makes an effort to explain its results in the context of an existing theoretical framework and attempts to position the new evidence within the context of developed markets.

The remainder of this paper is organized as follows. Section 2 reviews the international literature. Section 3 formulates the hypothesis while Section 4 presents the data and analyzes the methodology. Section 5 shows the results regarding the long-term performance of IPOs and Section 6 presents the regression outcomes. The robustness of our results is tested in Section 7. Finally, Section 8 concludes the paper.

2. Related literature

2.1. Theoretical framework

There are multiple theories which try to explain the concept of underpricing; the situation where a new issue yields a large gain (relative to its offering price) immediately after listing has been reported in many markets. Ibbotson and Jaffe (1975) were the first to speak about hot issue markets. In his principal agent model, Baron (1982) assumes that investment banks act as the agents of the issuers, which could cause a moral hazard situation. Ritter (1984a,b) presents the ex ante uncertainty theory while Beatty and Ritter

[2] Surprisingly, Kutsuna, Kiholm-Smith, and Smith (2009) report 1-year holding-period returns in excess of 200%.

[3] Gajewski and Gresse (2006) argue that for some countries (France, Belgium, Sweden, Poland), the hot period started in 1997. There are four countries that do not match the general pattern. For the Polish, Turkish, and to a lesser extent the Greek markets, 1995 and 1996 were also active periods.