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Cultural distance and foreign IPO underpricing variations

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ABSTRACT

This paper examines the impact of cultural distance on the underpricing of initial public offerings issued by foreign firms in the United States (foreign IPOs). Using a sample of 503 foreign IPOs from 27 countries for the 1980–2012 period, we find that greater cultural differences between U.S. investors and foreign domiciled issuers increase the underpricing of foreign IPOs. Our findings are robust after controlling for a country's legal environment, financial development, and corporate tax rates. We also find that the presence of prior public equity issues in the home market moderates the positive impact of cultural distance due to the increased transparency and visibility of foreign firms among U.S. investors. Our results suggest that cultural differences influence IPO underpricing through an information asymmetry channel and visibility reduces information asymmetry between foreign issuers and U.S. investors, which, in turn, mitigates the positive impact of cultural distance on the underpricing cost.

1. Introduction

The IPO literature includes numerous theories as to why underpricing occurs. Of these, asymmetric information (e.g., Rock, 1986; Benveniste and Spindt, 1989) is arguably the most widely accepted. In

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this paper, we extend the asymmetric information theory by examining 503 international firms making initial public offers in the United States (foreign IPOs) for the 1980–2012 period. When foreign firms offer IPOs in the U.S. market, differences in accounting standards, disclosure requirements, cultures, languages, legal protections, and law enforcement are likely to lead to increased information asymmetry between foreign issuers and U.S. investors. Cultural distance, measuring the degree to which shared norms and beliefs differ from one country to another, serves as a good proxy[1] for information asymmetry and play an essential role in explaining the determinants of foreign IPO underpricing variations in the U.S. market.

This paper contributes to the growing literature of cultural consequences on financial economics and provides further support to the asymmetric information theory. Prior literature interprets international IPO underpricing through the mechanisms of ex ante uncertainty (Engelen and van Essen, 2010) and the managerial control theory (Brennan and Franks, 1997). Following Zhu and Cai (2014), we employ cultural distance as a proxy for information asymmetry. People from dissimilar cultures are less likely to build trust with one another, and there are more uncertainties in predicting the behavior of others as well. Consequently, cultural dissimilarities increase the cost of information gathering (Giannetti and Yafeh, 2012), thus IPO issuers from countries with a greater cultural difference from the U.S. may be considered risker by U.S. investors. This risk resulting from asymmetric information between foreign issuers and U.S. investors is likely lead to the higher level of foreign IPO underpricing.

Following Kogut and Singh (1988) and Morosini et al. (1998), we measure the multidimensional cultural differences between the U.S. and other countries by using Hofstede (2001) four dimension scores[2]: uncertainty avoidance, individualism, masculinity, and power distance. We find that greater cultural differences between foreign issuers and U.S. investors increase underpricing costs for foreign IPOs. Our results hold after controlling a country's legal system, financial market development, and corporate tax rates.

In an attempt to identify what role, if any, each of the four subcomponents of cultural differences play in the foreign IPO underpricing variations, we also define the four subcomponents as the absolute value of the difference between the issuing country and the U.S. on Hofstede's four cultural dimensions, respectively: the uncertainty avoidance subcomponent (*UAI*), the individualism subcomponent (*IDV*), the masculinity subcomponent (*MAS*), and the power distance subcomponent (*PDI*).

We find a positive relationship between the underpricing of foreign IPOs and *UAI* and *IDV*. The dimension of uncertainty avoidance measures the level of acceptance of uncertainty and ambiguity (i.e., risk aversion level of a country). In contrast, the individualism dimension is linked to overconfidence behavior (Chui et al., 2010) and overconfidence in the perception of risk (Hackbarth, 2008). The results suggest that risk-averse U.S. investors may demand higher first-day returns when their risk preference and interpretation of risk are different from foreign issuers.

In addition, we add to the literature by providing a new insight in explaining the underpricing of international IPOs. Specifically, we test the joint effects of culture distance and the presence of prior equity offers in the home market in determining a foreign firm's underpricing cost. Having shares traded in the home equity markets prior to IPOs in the U.S. increases the information transparency and visibility of foreign firms among U.S. investors (Ball et al., 2013), and thus reduce intrinsic asymmetries of information between U.S. investors and foreign issuers. Consistent with this notion, we find that the presence of prior IPO issues in the home market moderates the positive impact of cultural distance. Our results suggest that visibility facilitates to reduce information asymmetry between foreign issuers and U.S. investors, which, in turn, mitigates the positive impact of cultural distance on the underpricing cost.

[1] See for example, Giannetti and Yafeh (2012) and Zhu and Cai (2014).

[2] Long-term orientation is fifth dimension, developed later based on the Chinese Value Survey of students, which covered only 23 countries. Long-term orientation emphasizes a forward-looking perspective. However, because the long-term orientation dimension has a quite different sample coverage when compared to the other four dimensions, it is not comparable to them and thus is excluded from our study.