



# What determines the market share of investment banks in Chinese domestic IPOs? ☆



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## ABSTRACT

In this paper, we empirically examine how government forces vis-à-vis market forces have affected the market share of investment banks in Chinese domestic IPOs over the period 1995–2010. Before 2005, only political connections significantly positively influenced the market share of investment banks. After 2005, the effect of political connections declined, while a low evaluation standard on IPO candidates and low underwriting fees now also significantly enhance market share. We explain these findings by the pro-competitive, yet partial changes that were introduced in the regulatory framework for IPOs, thereby emphasizing the need for a delicate policy coordination in marketization reforms.

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## 1. Introduction

Since 1978, China has initiated unprecedented reforms to re-model its centrally planned economy into a more market-oriented one. A focal point in those reforms has been to establish well-functioning stock markets, as stock market prices can contribute to a more efficient allocation of financial resources. Through an initial public offering (IPO), a firm lists itself for the first time on a stock exchange. Also, it raises extra capital to finance its prospective growth opportunities. Firms that are able to list and sell their shares at an attractive price likely find it easier to finance their investment projects. Well-functioning stock markets are therefore essential not only for the development of those listing companies but also for the economy as a whole (e.g., King & Levine, 1993; Levine & Zervos, 1998). According to the figures compiled by the National Bureau of Statistics, 2104 firms became listed in Shanghai or Shenzhen by the end of 2010, with total market capitalization reaching RMB 26.5 trillion. Correspondingly, China's domestic stock markets now rank as the world's second largest.

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Along the re-foundation of the stock exchanges in Mainland China at the beginning of the 1990s, the government has also allowed a whole new, mostly indigenous industry of investment banking to develop.<sup>1</sup> Yet, academic research on the role and the growth of those investment banks in Chinese domestic IPOs is non-existent to date. Investment banks, as repetitive agents in the IPO market, usually play a crucial role in the process of certifying, promoting, placing, and supporting a firm's offering (Brau & Fawcett, 2006; Chitru, Gatchev, & Spindt, 2005). Indeed, as an IPO is a one-time event for issuing firms, they face lots of questions, like the choice on the appropriate exchange to list and on how to satisfy the listing requirements. Moreover, they have to decide on the offer price for their stock, on their preferred investor base, on how to convince those investors to buy and hold the IPO shares, etc. For an IPO firm, becoming listed only once, it is too costly to acquire the required expertise to solve all those questions by itself. Moreover, a huge asymmetry in information exists among issuers and investors at the time of IPO. Investors might thus be hugely concerned about buying a 'lemon' when shares are sold directly by the issuer (Akerlof, 1970). Besides, the conflict of interests between issuers and investors cannot be ignored either, as issuers want to sell their shares at a high offer price, while investors have an interest in buying at a low offer price. Brealey, Leland, and Pyle (1977) were the first to argue that an intermediary can mitigate those information and incentive problems in the IPO market, which allows it to build a reputation and, correspondingly, a market share in IPO underwriting. Due to the repetitive nature of its IPO operations, this agent has to maximize its utility on not just one IPO, but on a series of subsequent IPOs. In other words, it should not behave opportunistically in any single IPO to avoid jeopardizing its chances to attract future IPO business. It therefore has to develop and maintain a good reputation among issuers and investors, which is crucial for its growth and survival (e.g., Beatty & Ritter, 1986; Chemmanur & Fulghieri, 1994). By providing high-quality services at a reasonable price, investment banks can thus also contribute to well-functioning stock markets.

Over the past two decades, Chinese investment banks had to build up their market share in IPO underwriting from scratch. During this process, the regulator at first has put investment banks under heavy administration and has intervened directly in the IPO market to guide banks to gradually take up a role in certifying the quality of issuers. Yet, those heavy regulatory procedures may also have opened the door for an unequal treatment across investment banks, thereby favouring the ones with better political connections. While prior research has documented the impact of political connections on firms' financing decisions and firm value (e.g., Du & Girma, 2010; Faccio, 2006; Li, Meng, Wang, & Zhou, 2008), we analyse their effects on investment-bank market shares in IPO underwriting. Besides, this institutional aspect makes the Chinese IPO market different from any Western IPO market, where the market mechanism itself plays a major role in rewarding and punishing investment banks based on their behaviour in the IPO market. For IPOs in the U.S.A., Dunbar (2000) indeed finds that investment banks performing poorly in terms of IPO certification, pricing, and research coverage subsequently lose market share.<sup>2</sup> Nonetheless, along with the growth of the Chinese IPO market, the regulator has gradually reduced its direct market intervention and has allowed market forces to become more influential. Those institutional changes now enable us to explore whether and how the nature and price of underwriting services provided by investment banks have become influential in determining their market share in the Chinese IPO market.

Our paper, by examining how pro-competitive changes in the IPO regulatory framework over time have influenced investment banks' market share in IPO underwriting, also provides insights into the functions (not) performed by those investment banks in the IPO market over the period 1995–2010. Micro-economic theory suggests that competition can bring about allocative efficiency, forcing prices to equal marginal cost (Baumol & Blinder, 2011; Mansfield & Yohe, 1991). Product market competition is usually an important external governance mechanism, which might limit managerial discretion and hence reduce organizational slack. So, it fosters managerial incentives to perform and ensures that only the best firms in an industry survive. Interestingly, while the Chinese regulator embraced a pro-competitive regulatory regime over time, it did not introduce this framework at once, but in a rather gradual way. Step by step, the subsequent reforms liberalized the provision of investment banking services and the pricing of those services. Our paper, by examining how the marketization process in IPO underwriting in Mainland China has affected investment banks' market shares, can also contribute to the debate on the importance of policy coordination in marketization (Dewatripont & Roland, 1992; Tao & Xu, 2006; Zhou, 1993). What's more, the Chinese setting is quite interesting to examine this research question, as all investment banks active in underwriting Chinese domestic IPOs started with state ownership. Moreover, control of those investment banks never shifted from the central government to the local government or to the private sector during our sample period. Our study thus also contributes to the theoretical discussion whether stimulating product market competition by itself can put discipline on firms in a context where the form and type of firm ownership does not change (see, e.g., Vining & Boardman, 1992).

Our empirical results indicate that prior to 2005 only political connections significantly positively affected the market share of lead underwriters in IPOs. On average, an investment bank controlled by the central government had a market share that was about seven percentage points larger than that of a bank controlled by a local-level government or by a private owner. As the average market share in that period was only 3.7%, strong political connections thus created a huge advantage for investment banks. After 2005, this favourable effect declined, but nonetheless remains significant at about five percentage points. Meanwhile, investment banks applying a low evaluation standard on IPO candidates and/or investment banks charging low underwriting fees were able to

<sup>1</sup> Chinese investment banks were all established by local owners. Foreign investment banks have had little, if any, influence on the development of the industry. At present, investment banks still have to be majority-owned by a domestic owner in order to be able to underwrite IPOs in Mainland China. Morgan Stanley founded the first jointly owned investment bank in 1996. Other foreign investment banks (Deutsche Bank, Goldman Sachs, LCL, SMBC, and UBS) were allowed to set up joint ventures only as of 2004. Yet, those joint ventures have advised only 60 A-share IPOs (2.9%) up till the end of 2010.

<sup>2</sup> Dunbar (2000) is the only study to date that has examined how the quality and the price of underwriting services affect investment-bank market shares in IPOs. His sample consists of U.S. IPOs on the New York Stock Exchange, American Stock Exchange, and Nasdaq between 1984 and 1995. He finds that underpricing too much, being associated with IPOs with poor long-run performance and with withdrawn offers, experiencing a decline in analyst reputation, and charging too high underwriting fees all reduce the subsequent market share of investment banks. He further detects that non-established investment banks choose to focus on a specific industry, while the more established banks diversify their industry focus.

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