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Does institutional reform improve the impact of investment bank reputation on the long-term stock performance of initial public offerings?

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ABSTRACT

This study examines the impact of investment bank (IB) reputation on the long-term stock price performance of Chinese initial public offerings (IPOs) over the period 1993 to 2010. For comparison purposes, the whole sample period is separated into two sub-periods by the 2001 IPO allocation system reform: the quota system period from January 1st, 1993 to April 22nd, 2001 (hereafter, the pre-reform period) and the approval system period from April 23rd, 2001 to December 31st, 2010 (hereafter, the post-reform period). Using two time-varying proxies for IB reputation, we find *no* impact of IB reputation on the three-year buy-and-hold abnormal returns (BHARs) during the pre-reform period, but a significantly *positive* impact during the post-reform period. Our results are robust to various alternative methodological approaches in controlling for the problem of endogeneity and the cross-sectional correlations in abnormal returns.

1. Introduction

A growing body of theoretical and empirical research suggests that financial intermediaries improve information quality in capital markets, and in turn optimize resource allocation. Investment banks (IBs), as important financial intermediaries in the stock market, signal and certify issuer earnings quality during the initial public offering (IPO) process, helping mitigate information asymmetry between issuers and prospective investors (Booth & Smith, 1986; Carter & Manaster, 1990). A theoretical model developed by Chemmanur and Fulghieri (1994) implies that the more prestigious the IB, the more effective it will be in decreasing the influence of information asymmetry during the IPO process. Carter and Manaster (1990), Megginson and Weiss (1991), Carter, Dark, and Singh (1998), and others empirically examine various samples of IPOs issued in the 1980s and find a negative relationship between IB reputation and IPO initial returns. They attribute the lower level of IPO underpricing to the superior certification benefit provided by more prestigious IBs. The role of IBs reflects not only on their activity in the primary market, but on the entire array of activities in which they get involved. For example, prestigious IBs can enhance the long-term performance of IPOs through actively participating in aftermarket transactions (Carter et al.,

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1998; Michaely & Shaw, 1994). It is reasonable to presume that prestigious IBs usually benefit from their excellent network of brokers to distribute IPO shares and from their influential analyst coverage in the aftermarket (Carter et al., 1998; Jenkinson & Ljungqvist, 2001). For example, in examining 947 IPOs over the period 1984 to 1988, Michaely and Shaw (1994) report that IPOs managed by more prestigious IBs significantly outperform their counterparts in the long term, in line with Carter et al. (1998) and Dong, Michel, and Panders (2011).

Although the influence of IB reputation on IPO price performance has been well-documented in some developed markets,[1] it may not be realistic to expect a similar effect in emerging markets where there exist more severe information asymmetry and much lower level of information efficiency (Chan, Menkveld, & Yang, 2008; Harvey, 1995). In such inefficient markets, it takes longer for any information to be fully incorporated into asset prices, which can cause the role of IBs in emerging markets to be distinct from that observed in developed markets. However, very little attention has been paid to the impact of IB reputation on IPO price performance in emerging markets. This study thus attempts to fill the gap by shedding new light on the China stock market, one of the largest and most important emerging markets in the world. In particular, its institutional setting has important characteristics that are different from and independent of those in developed markets, i.e., the dominance of individual investors, the long lag between the offering and listing dates, and the existence of a large number of non-trading shares, etc., which have been extensively criticized as an indicator of operating inefficiency (Boycko, Shleifer, & Vishny, 1996; Chan, Wang, & Wei, 2004). The China stock market, therefore, provides a unique arena to test whether the role of IB reputation helps improve informational efficiency and transparency in an emerging market context.[2]

In addition, our particular attention to the China stock market is motivated by further consideration that the role of IBs during the IPO process has substantially changed following the IPO allocation system reform in 2001. Specifically, a *quota* system was adopted in the China stock market before 2001, under which the aggregate quantity of equity to be issued each year is determined by the central government. The China Securities Regulatory Commission (CSRC), the regulatory authority of the China securities market on behalf of the central government, rather than IBs, was in charge of checking and supervising IPO firms' credit, business risk, and offering size, etc., as well as determining the pricing and timing of IPOs. The quota system was replaced by a more market-oriented *approval* system in April 2001, under which the central government no longer placed a cap on the flow of funds raised or the number of IPOs issued in each year. Since then, Chinese IBs have been granted more freedom in pricing IPOs and taken more responsibility to evaluate issuers' credit standing as well as risk and thereby to recommend qualified firms to the CSRC for the final offering approval. Such institutional reform in the China stock market makes it quite interesting to identify whether the enhanced role of IBs is helpful in improving the stock performance of IPOs in the long term. To the best of our knowledge, this is the first systematic and comprehensive study that comparatively examines the impact of IB reputation on the long-term stock performance of Chinese IPOs before and after the 2001 IPO allocation system reform.

For comparison purposes, we separate the whole sample period into two sub-periods: the quota system period from January 1st, 1993 to April 22nd, 2001 (hereafter, the pre-reform period) and the approval system period from April 23rd, 2001 to December 31st, 2010 (hereafter, the post-reform period). Using a sample of 1749 Chinese IPOs with the post-issue return evidence up to December 2013, we find some interesting evidence and make significant contributions to the finance literature in several aspects. Specifically, previous studies generally ignore the influence of IB reputation in explaining IPO price anomalies in emerging markets (Yong, 2007), mainly due to the non-existence of a transparent and convincing ranking system regarding IB reputation. We supplement the finance literature by constructing two novel proxies for IB reputation, based on a three-year moving average of the aggregate gross proceeds raised or the total number of IPOs managed by each IB in each calendar year. Unlike previous measures generally based on the simple assumption that IB reputation remains unchanged over the whole sample period (Carter & Manaster, 1990; Megginson & Weiss, 1991; Carter et al., 1998; Chen, Shi, & Xu, 2013), our proxies are thus dynamic and reflect changes in IB reputation over a long period of time, i.e., enormous takeovers of Chinese IBs occurring over the past two decades. In particular, we provide a complete list of 165 Chinese IBs that got involved in at least one IPO over the period 1993 to 2010, based on both proxies for IB reputation, as well as a list of major takeovers of Chinese IBs occurring throughout the whole sample period (see Appendices I & II).

We find that IB reputation has *no* significant impact on the long-term stock performance of IPOs during the pre-reform period, but a significantly *positive* impact during the post-reform period. Specifically, during each allocation system period, all IPOs are sorted into three *reputation* groups: Low, Medium, or High, according to whether the value of IB reputation is included within the lowest 30, middle 40, or highest 30 percentile, respectively. We find that the difference in mean three-year buy-and-hold abnormal returns (BHARs) of IPOs between Low and High *reputation* groups (0.573%) is statistically insignificant (t-stat = 1.24; Kruskal–Wallis $\chi^2 = 1.64$), during the pre-reform period. However, during the post-reform period, the mean three-year BHAR of IPOs in High *reputation* group (12.023%) is significantly higher than that of IPOs in Low *reputation* group (0.556%) at the 1% level (t-stat = 3.43; Kruskal–Wallis $\chi^2 = 19.25$). Our results are robust to several alternative methodological approaches, i.e., the standard two-stage least squares (2SLS) estimation and the Heckman (1979) two-stage procedure, in controlling for the problem of endogeneity, as well as the calendar-time portfolio approach in correcting for the

[1] Empirical evidence shows that IBs help reduce information asymmetry in the US (Beatty & Ritter, 1986; Booth & Smith, 1986; Chemmanur & Fulghieri, 1994; Carter et al., 1998; Dunbar, 2000; Lee & Masulis, 2011), in the UK (Slovin, Sushka, & Lai, 2000), and in Japan (Cooney, Kao, & Schallheim, 2003).

[2] More institutional features of the China stock market are as discussed in Wang et al. (2008), Su and Bangassa (2011), and Su and Brookfield (2013), among others.