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The impact of institutions, ownership structure, business angels, venture capital and lead managers on IPO firm underpricing across North Africa

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ABSTRACT

This paper examines the determinants of IPO underpricing in a unique and comprehensive, sample of 86 IPO firms from across North Africa between 2000 and 2013. The findings suggest that, underpricing is used as a mechanism by which to stimulate excess demand (subscription) for newly, issued stock in order to create a relatively small but highly dispersed, and thus disempowered, minority shareholder base. Domestic venture capital and to lesser extend business angels are, associated with elevated underpricing while the reputational impact from foreign venture capital and, lead managers infers lower underpricing. In terms of institutions and state-level corruption control, policies are most closely linked to substantial reductions in underpricing.

1. Introduction

The often considerable wealth transfer from entrepreneurs and corporate insiders to minority outside investors participating in the firm for first time in its initial primary offering (IPO) debut through substantially deflated issue prices in relation to the true market value of stock has been the subject of a considerable literature (see Smart and Zutter (2003) for detailed review). However the overwhelming majority of this literature is focussed on uncovering the underlying agency-based motivations of

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insiders for initiating IPO underpricing of stock and the signals selectively available to IPO firms that influence relative levels of underpricing within a single country context. These single country studies are overwhelmingly dominated by those focussed on large developed US IPO market (e.g. Smart and Zutter, 2003; Arthurs et al., 2008) alongside other developed markets such as UK (Brennan and Franks, 1997) and more recently UK and France (Bruton et al., 2010) and Germany (Tykova and Walz, 2007). It is only more recently that a cross country comparative literature has started to emerge seeking to elaborate on the institutional and corporate governance (at legislative level) differences that impact on often considerable variations in IPO underpricing in worldwide equity markets (see Boulton et al., 2010). However a shortfall in this emerging latter cross-country comparative literature is the almost exclusive focus on the impact of high level institutional differences pervasive across countries with the wholesale omission from consideration of important market participants, such as lead managers and private equity entities. Their presence in particular acts to mitigate asymmetric information surrounding the transformation of the firm from private to public realm during the IPO process. My first contribution to literature is in addressing this shortfall in studying the impact of both lead managers and private equity entities alongside differences in national institutional quality on IPO underpricing.

North Africa forms the distinctive geographic focus of this study due to the proximity to Europe and the distinctive nature of the region's economy with this being made up from extensive interlinked networks of firms that are constituent to one, or often several overlapping, business groups controlled by large extended families. The region's IPO markets have also been largely omitted from study in the literature with the exception of the inclusion of Egypt in a wider 49-country dataset of La Porta et al. (1997) and Hearn (2011, 2013). The former La Porta study focuses on country-level institutions while the latter two studies by Hearn focus on the role and impact of extended family networks firstly on IPO firm underpricing and secondly on aggregate board salary, an agency-based incentive measure. The region is also subject to an incongruous mix of French civil code law formal institutions, themselves shaped largely on original unreformed Napoleonic framework since their adoption during colonial rule, and deeper informal institutions making up the fabric of Maghreb society, based on classical Islamic shari'ya law (Hearn, 2011; Kuran, 2004). This incongruity alongside a pronounced role of state in development, eschewed through the Dirigiste tradition in Francophone countries and socialism in Egypt, has been attributed to economic and social structural rigidities that gave rise to the recent unprecedented period of political and social upheaval, popularly termed as the Arab Spring (BBC News, 2011). Consequently there is considerable national policy-level emphasis on economic rejuvenation across the region with added importance attached to both the role of entrepreneurs and growth firms as well as their ability to access finance through capital markets and private equity entities. As such it is timely to undertake a study on this region's primary equity markets and the determinants of IPO underpricing.

The role of early-stage private equity financiers as well as essential market participants to IPO offers such as underwriters in determining levels of underpricing has received considerable attention in the literature. Private equity finance is well recognized in being strategically placed to provide capital to firms subject to extremely high asymmetric information, such as those with minimal track records at start-up (see Berger and Udell, 1998 for an extensive literature review). A key differentiating feature of private equity as opposed to investors simply seeking to derive benefits from diversification of risks associated with personal portfolios is in the level of active management and participation undertaken within portfolio investee firms (Barry et al., 1990). As such private equity financiers are best placed to provide superior monitoring and surveillance of investee firms and their management and thus have superior access to information otherwise either unavailable or prohibitively costly to obtain for more widely dispersed outsider investors. However while the certification of value (signalling theory) of private equity entities is well documented in the literature (see Barry et al., 1990; Bruton et al., 2010) there is conjecture as to the impact of this on IPO underpricing. In recognition of the superior monitoring role played by venture capitalists (VC), Barry et al. (1990) argues that VC involvement in a firm leads to their maintaining a larger equity stake following the IPO with less underpricing than comparable non-VC backed firms. In this way VC-backing certifies the intrinsic value of the firm to the market and reduces uncertainty (asymmetric information) reflected in the necessity for larger IPO discounts to attract minority investors (Leland and Pyle, 1977). This certification view is also supported by Megginson and Weiss (1991) and Gompers (1996). However a contrasting view of the