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# Corporate governance, growth opportunities, and the choices of cross-listings: The case of Chinese ADRs



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### ABSTRACT

We examine the inter-relationships among internal governance, firm attributes, and the listing choices of American Depositary Receipts (ADRs) for Chinese firms. We find that Chinese ADRs exhibit better performance, higher growth opportunities, and stronger internal governance than domestic firms prior to and after ADR listings. Furthermore, we find that the listing choices are influenced by Chinese firms' growth opportunities and internal governance. Those with lower growth opportunities tend to choose a Level 1 listing that restricts capital-raising but does not require U.S. regulatory compliance. In contrast, those with higher growth opportunities prefer a Level 3 listing that permits public offerings but requires full regulatory compliance. As a result, the improvement in the internal governance of Level 3 ADRs is more pronounced than that of Level 1 ADRs in the post-listing period. This suggests that the extent of improvement in governance is related to the firm attributes and the motivations behind cross-listings.

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## 1. Introduction

Firms generally benefit from overseas listings. They not only circumvent regulatory barriers and lower information asymmetry (Alexander et al., 1987) for overseas investors but also reduce agency conflicts (Lel and Miller, 2008), improve disclosure standards (Domowitz et al., 1997), and strengthen governance practices (Dojidge et al., 2009b). As a result, cross-listing firms tend to experience lower cost of capital or

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higher firm valuation. Karolyi (2006) finds that among the 2300 internationally cross-listed stocks by the end of 2002, more than 2000 are cross-listed on U.S. exchanges. The preference for U.S. markets is not surprising given the size of its capital market, the quality of law enforcement, and the more stringent disclosure requirements.

Much of the literature that investigates cross-listings in the U.S., however, overlooks the type of listings available for a firm to choose. Under the American Depositary Receipt (ADR) program, there are four listing options—Level 1, Level 2, Level 3, and Rule 144A. They vary in terms of access to U.S. capital markets and governance and disclosure requirements. The benefits of cross-listings can therefore differ substantially depending on the option chosen. Consequently, choosing an ADR program is important when a firm decides to cross-list in the U.S. For example, a firm with high growth opportunities seeking a larger investor base may prefer the Level 3 program, which permits public offerings but requires full compliance with U.S. regulatory standards. However, a firm with low growth opportunities and weaker governance (i.e., incur high compliance costs) may choose the Level 1 program, which restricts equity raising but does not require U.S. regulatory compliance. Examining the listing choice may therefore provide further insights into different motivations behind cross-listings, which in turn are related to internal governance and firm attributes.

Extending the current literature, this paper investigates the inter-relationships among Chinese firms' internal governance, firm attributes, and the choice of ADR listings. More specifically, we seek to answer the following three related questions. First, are Chinese ADRs characterized by superior firm performance, higher growth potential, and stronger internal governance than their domestic counterparts prior to the ADR listing period? Second, do Chinese ADRs continue to improve their governance practices in the U.S. governance environment in the post-listing period? Third, how do the internal governance and firm attributes of Chinese ADRs influence their listing choice, if any, to gain desirable benefits from cross-listings?

The answers to these questions should add to the literature on the benefits of cross-listings in the following ways. First, previous studies examining the relationship between firm performance and corporate governance are often plagued by the endogeneity problem. Since cross-listings in a stronger governance environment are an exogenous event that isolates the effect of governance from that of firm performance, our investigation into the relationship prior to and after the ADR listings should mitigate this problem. Our study could therefore shed more light on the changes in governance and firm performance.

Second, China has recently become the second largest economy in the world, and an increasing number of Chinese firms have cross-listed in the U.S. Interestingly, the number of Chinese ADRs has more than doubled from previous years combined during the global financial crisis (GFC) from 2007 to 2009.<sup>1</sup> It appears that the GFC has had little impact on the benefits of cross-listings for Chinese firms as Zhang and King (2010) suggest that they continue to be successful and exhibit higher growth and returns during the crisis period. It follows that as the Chinese economy continues to grow, more firms will seek cross-listings. More importantly, China provides a unique institutional background where the majority of publicly listed firms are state-owned enterprises (SOEs). Since SOEs are less likely to experience external financing constraints and therefore seek external capital, examining how state ownership affects the choice of ADR listings would be an interesting investigation.

Third, although earlier studies find that firms bond themselves by cross-listing in a stronger governance regime, thus improving their governance practices, the studies could not examine the extent of the improvement in governance across firms in the post-listing period. Linking the choice of ADR programs with different regulatory compliance to firm attributes of cross-listed firms makes it possible to explain why Chinese ADRs might differ in their post-listing governance practices. The findings in this study should therefore enhance our understanding of the differential impacts of cross-listings on firms' internal governance.

Consistent with earlier studies, we find that Chinese ADRs are on average larger and less financially leveraged, and experience higher returns and growth rates than domestic firms before cross-listing. Chinese firms also exhibit stronger governance structure in the form of smaller boards, a higher proportion of independent directors, insider ownership, and institutional ownership. Within cross-listed firms, although there is little difference in governance measures, Level 3 ADRs tend to exhibit a higher growth rate than Level 1 ADRs. This may explain why Chinese firms with higher growth potential and thus greater external financing needs tend to choose the Level 3 program.

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<sup>1</sup> There were 98 new ADR listings from 2007 to 2009 compared to 63 ADRs from 2003 to 2009.

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