The valuation of ADR IPOs

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ABSTRACT

We examine the valuation of ADR IPOs and find that they are valued similarly to U.S. domestic IPOs but significantly higher than U.S. seasoned firms. This higher valuation is not caused by differences in firm size, growth opportunity, profitability, listing exchange, diversification benefit, foreign exchange risk, investor protection, or market liquidity as suggested by previous studies. Moreover, they experience significant declines in earnings and their stocks underperform U.S. seasoned by more than 20% in the three years after IPO. We show that ADR IPOs are timed to take advantage of overoptimistic in U.S. equity markets, supporting windows of opportunity theory.

1. Introduction

An American depositary receipt (ADR) is a negotiable security that represents shares of a non-U.S. company that trades in U.S. dollars in the U.S. financial markets. In recent decades, the ADR market has grown rapidly and a lot of research has been conducted into the motivation, return behavior, diversification benefit, liquidity, possible theoretical initial public offering (IPO) underpricing, and underwriter gross spreads of ADRs. Our study is motivated by lack of extensive research in existing literature exploring whether ADR IPOs are valued differently from U.S. domestic companies. The answer to this question has rich implications on how the market values securities contingent on their origination.

It can be argued that ADR IPOs should be valued higher than U.S. domestic companies. Several studies, including Alaganar and Bhar (2001) and Kabir et al. (2011), suggest that U.S. investors can achieve diversification benefits by using ADRs. Because of the diversification benefit, U.S. investors may demand a lower expected return and consequently offer higher valuation for ADR IPOs.

Moreover, based on the lower underpricing for ADR IPOs, Ejara and Ghosh (2004) argue that ADR IPOs actually have lower information asymmetry than U.S. domestic IPOs. Given that investors usually demand a higher rate of return to compensate...
for higher information risk (Easley and O’hara, 2004; Lambert et al., 2007). Ejara and Ghosh (2004)’s argument also implies that investors will value ADR IPOs higher than U.S. IPOs.

The windows of opportunity theory about IPOs posited by Ritter (1991) has significant implications regarding the valuation of ADR IPOs as well. This theory suggests that investors are periodically overoptimistic about certain types of companies and firms selling IPO shares to take advantage of the high valuation. Depending on how optimistic investors are about non-U.S. firms, ADR IPOs may be valued higher than U.S. domestic IPOs and/or U.S. seasoned firms.

In contrast, there are several factors that may cause ADR IPOs to be valued lower. One possible factor is liquidity. Bacidore and Sofianosnon (2002) find that non-U.S. stocks listed on NYSE have lower liquidity than U.S. stocks. The lower liquidity implies that investors will demand higher expected return from ADRs (see, for example, Amihud and Mendelson, 1989). Therefore the valuation of ADR IPOs will be reduced relative to U.S. domestic firms. The second possible factor is information risk. Bacidore and Sofianos (2002) find that the lower liquidity for non-U.S. stocks is primarily due to higher information asymmetry and increased adverse selection risk. The higher information risk for ADRs also implies lower valuation for ADR IPOs. Exchange rate risk may also potentially affect ADR valuation. Bin et al. (2004) find that ADRs have significant exposure to exchange rate risk. Investors may demand a premium risk to compensation for the exchange rate risk. This will also cause ADR IPOs to be valued lower than U.S. firms.

Furthermore, the corporate governance literature has additional implications regarding the valuation of ADR IPOs. La Porta et al. (2002) find that in countries with better protection of minority shareholders firms are valued higher. With this notion, since most ADRs come from countries with lower investor protection than that of U.S., the ADR IPOs are likely to be valued lower than the U.S. companies.

Using a sample of total 144 level III ADRs that went public in the U.S. between 1993 and 2014, we examine the valuation of ADR IPOs. We show that valuation measures based on Price/Earnings (P/E) multiple are not appropriate because ADR IPOs experience much more fluctuation in earnings afterwards. Specifically, one average, the earnings of ADR IPO firms in the three fiscal years after IPO year decline by about 78% while the earnings of comparable U.S. IPO firms decrease by less than 9% and those of comparable seasoned firms decline by about 48%. In this case, valuation measures based on earnings in the IPO year will suggest that ADR IPOs are undervalued if the market values ADR IPOs based on expected earnings in the long term. Therefore we measure valuation of ADR IPOs using a P/V ratio based on Tobin’s Q, which has much lower short-term fluctuations. We find that a typical ADR IPO firm is valued at a similar level as a comparable U.S. domestic IPO firm. When compared to a similar U.S. domestic seasoned firm, the ADR IPO is actually valued around 30% higher.

Consistent with the argument that ADR IPOs are overvalued, we find that ADR IPO stocks underperform comparable U.S. seasoned firms by more than 20% in the three years after IPO. These results imply that investors may be over-optimistic about future earnings growth of ADR IPO firms at the time of issuance, therefore providing support to the windows of opportunity theory.

We explore additional factors affecting the valuation of ADR IPOs in regressions and find that the higher valuation of ADR IPOs relative to domestic seasoned firms cannot be explained by firm size, growth opportunity, profitability, or the listing exchange. ADR IPO stocks do offer diversification benefit in terms of lower correlation with the U.S. broad market. However, the lower correlation does not explain the higher valuation of ADR IPOs in the regressions. We find that ADR IPO stocks actually have higher market liquidity than U.S. domestic seasoned firms, but ADR IPOs are still valued significantly higher than U.S. seasoned firms after controlling for liquidity. Therefore we feel differences in market liquidity play a limited role in explaining the higher valuation of ADR IPOs. Because liquidity measures can be used as proxies for information asymmetry/risk, this result does not support the argument that the higher valuation is mainly caused by lower information risk for ADR IPOs. We also add explanatory variables to control for foreign exchange risk and investor protection but the results do not change significantly. In contrast, the valuation of ADR IPOs is not significantly different from that of U.S. domestic IPOs in all regressions.

To our knowledge, this paper is the first one to explore ADR IPO valuation and to compare the valuation of ADR IPOs with U.S. domestic firms. The evidence suggests that windows of opportunity for new issues may exist not only for domestic firms but also for international issuers. Our tests of different theories regarding ADR valuation enrich our understanding of cross-country finance. They are of interests to researchers who study market efficiency, management opportunism, firm valuation or international listing of firms. Our study provides useful valuation implications to practitioners, such as investment bankers who underwrite ADRs and asset managers who invest in ADRs.

The rest of the paper is organized as follows: in Section 2 we review the literature and present various hypotheses that could potentially explain the valuation of ADR IPOs; in Section 3 we describe the sample and methodology; in Section 4 we present the empirical test results; Section 5 concludes the paper.

2. Literature and hypotheses

Harvey (1995), Bekaert and Urias (1999), De Santis and Gerald (1997) have found that U.S. investors can gain diversification benefits by investing in emerging markets. As suggested by Alaganar and Bhar (2001), ADRs provide U.S. investors an alternative to investing in foreign equities directly without the inconveniences such as currency conversion and foreign settlement procedures. Consistent with this argument, Kabir et al. (2011) document a high degree of substitutability between ADRs and country indices and Alaganar and Bhar (2001) find a low correlation between the U.S. market and ADRs.
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