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The market reaction to cross-listings: Does the destination market matter?

Peter Roosenboom, Mathijs A. van Dijk *

Rotterdam School of Management, Erasmus University, P.O. Box 1738, 3000 DR Rotterdam, Netherlands

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ABSTRACT

This paper examines (i) whether market reactions to cross-listings differ across destination markets and (ii) to what extent the following explanations for value creation around cross-listings can account for differences in market reactions across cross-listings on various destination markets: overcoming market segmentation, increased market liquidity, improved information disclosure, and better investor protection ("bonding"). We analyze 526 cross-listings from 44 different countries on eight major stock exchanges and document significant announcement returns of 1.3% on average for cross-listings on US exchanges, 1.1% on London Stock Exchange, 0.6% on exchanges in continental Europe, and 0.5% (not significant) on Tokyo Stock Exchange. We find evidence consistent with improved disclosure and bonding creating value for cross-listings on US exchanges, while overcoming segmentation and bonding are associated with higher announcement returns on the London Stock Exchange. The evidence is mixed for continental European exchanges and for Tokyo. Our results highlight the role of the destination market in value creation around cross-listings.

1. Introduction

Cross-listings on US exchanges are associated with significantly positive stock market reactions (Foerster and Karolyi, 1999; Miller, 1999; Doukas and Switzer, 2000). Recent research examines (and generally finds support of) four possible explanations for the valuation gains to overseas listings: overcoming market segmentation, increased market liquidity, improved information disclosure, and better investor protection ("bonding").[1]

However, the recent literature largely ignores cross-listings on non-US exchanges. Neglecting these cross-listings is likely to lead to an incomplete understanding of the impact of cross-listings on firm value and of the sources of valuation changes around cross-listings. In this paper, we investigate whether the valuation gains to overseas listing on US and non-US stock exchanges depend on the characteristics of the destination market.

We investigate the stock price reaction to 526 cross-listings from 44 different countries on eight major stock exchanges in the US, the UK, continental Europe, and Japan in the period 1982–2002. The key contribution of our paper is that we are able to test the power of each of the four explanations for the valuation benefits of cross-listings for the different destination markets.

Our paper is related to the study of Sarkissian and Schill (2009). They investigate the long-term valuation effects of a large sample of cross-listings on different markets. They examine whether the valuation effects of cross-listings are permanent and find little evidence that they are. We add to their study in several ways. First, we examine the short-term stock price reaction at the time of announcement of the cross-listing instead of the abnormal firm performance during a 20-year period around the cross-listing. Although identifying reliable announcements dates is an important concern in our approach, looking at these much longer windows leads to observed valuation gains that may not be directly attributable to the cross-listing, since the long-term performance of companies depends on many different factors. Second, Sarkissian and Schill (2009) include country characteristics in regressions of long-run abnormal firm performance, but they do not compare the average valuation effects of cross-listings on individual destination markets as we do in our paper. Third, we allow the coefficients on country and firm characteristics to be different for different destination markets. This approach enables us to uncover which characteristics can explain differences in abnormal returns for which destination markets. Fourth, we include a substantially larger number of firm characteristics in our analysis.

We find a statistically significant abnormal return around the announcement date of 0.98% on average for the overall sample.

* Corresponding author. Tel.: +31 10 40 81124; fax: +31 10 40 89017.
E-mail addresses: proosenboom@rsm.nl (P. Roosenboom), madijk@rsm.nl (M.A. van Dijk).

[1] See Karolyi (1998, 2006) for comprehensive reviews of the cross-listings literature.

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In line with expectations, cross-listings on US exchanges are associated with the highest valuation gains. US exchanges are generally considered to have the largest shareholder base, the deepest and most liquid markets, the most stringent disclosure requirements, and the strongest investor protection of financial markets worldwide. In particular, the abnormal return of cross-listings on Nasdaq or NYSE is 1.29% on average. Cross-listings in London, continental Europe, and Tokyo yield an average abnormal return of 1.09%, 0.58%, and 0.45%, respectively. The abnormal return for cross-listings in Tokyo is not statistically significant.

Firms from emerging markets reap significantly larger benefits from cross-listing than firms from developed markets. Firms from emerging markets show an announcement return of 2.32%, while firms from developed economies show a return of 0.68% (difference significant at the 1% level). However, this simple classification does not allow for a distinction between various sources of value creation in cross-listings. Emerging markets are characterized by the combination of investment barriers, low market liquidity, low accounting standards, and weak investor protection. Therefore, we use a host of different market and firm characteristics to measure the importance of alternative explanations for value creation in cross-listings.

Our evidence is broadly consistent with disclosure and investor protection playing a role in the value creation of cross-listings on US markets. Market segmentation and investor protection are significantly related to abnormal returns for firms cross-listing in London. Measures of the four explanations of value creation suggested by the literature have little power in explaining cross-listing returns for Europe and Tokyo. These results raise the question which underlying forces drive differences in value creation on these exchanges. We invite future theoretical and empirical work to address this issue.

2. Explanations for valuation gains around cross-listings

Foerster and Karolyi (1999), Miller (1999), Doukas and Switzer (2000), and Salva (2003) present evidence of positive valuation gains for firms that cross-list on Anglo-Saxon stock exchanges. These results contrast with earlier studies that report an insignificant stock price reaction in the listing month for US firms listing their shares in London, Tokyo, Toronto, or continental Europe (Lee, 1991; Varela and Lee, 1993; Lau et al., 1994). In this paper, we compare cross-listings on non-US exchanges with those on US exchanges to examine the role of the destination market and firm characteristics in value creation around cross-listings. This section provides a short overview of the four different explanations for the valuation gains to cross-listings put forward by recent theoretical and empirical research.

2.1. Market segmentation

The traditional argument for why cross-listing augments firm value is that it overcomes international investment barriers and thus leads to a reduction in the cost of capital, as the risk premium resulting from the investment barriers dissipates (Errunza and Losq, 1985). According to the market segmentation hypothesis, the valuation gain around the cross-listing thus depends on the degree to which the home country is integrated in the world market. Miller (1999) finds that cross-listings on US markets are associated with significantly higher announcement returns for firms from emerging countries than for firms from developed markets. Lins et al. (2005) emphasize the importance of access to external capital markets, especially for emerging markets firms. Karolyi (2004) finds that the expansion of ADR programs originating from 12 emerging markets is associated with greater integration with world markets.

2.2. Market liquidity

Cross-listings on deeper and more liquid equity markets could lead to an increase in the liquidity of the stock and a decrease in the cost of capital. Foerster and Karolyi (1998) show that cross-listings of Canadian firms in the US are associated with an increase in trading volume and a decrease in effective spreads. Smith and Sofianos (1996) document a substantial increase in the combined value of trading for a sample of foreign listings on NYSE. Silva and Chávez (2008) find that Latin American firms with an ADR do not always exhibit a liquidity advantage in the local market. Halling et al. (2008) document that for cross-listings on US exchanges, the fraction of trading that occurs on the destination market is greater for firms from countries that are geographically close to the US and for firms from less developed countries.

2.3. Information disclosure

Cross-listing on a foreign market can affect a firm's information environment. Saudagaran and Biddle (1992, 1995) argue that strict listing and accounting regulations deter cross-listings. However, Cantale (1996), Fuerst (1998), and Moel (2001) show that firms can use a cross-listing on markets with stringent disclosure requirements to signal their quality to outside investors. Some exchanges have more stringent disclosure requirements than others, but cross-listings do not affect the information environment of firms through compulsory disclosure alone. Baker et al. (2002), Lang et al. (2003a,b), show that cross-listings are associated with increased media attention, greater analyst coverage, better analysts' forecast accuracy, and higher quality of accounting information.

2.4. Investor protection

Coffee (1999), Stulz (1999), and Black (2001) argue that firms can "bond" themselves by cross-listing on a stock exchange with higher standards of investor protection in order to protect minority shareholders. Doidge et al. (2004) model the cross-listing decision as a trade-off between private benefits of control and taking advantage of growth opportunities by using bonding to reduce the cost of capital. They show that companies with a cross-listing in the US have a higher valuation than non-cross-listed corporations, especially when they have high growth opportunities. Reese and Weisbach (2002) and Lins et al. (2005) show that cross-listings by firms from countries with weaker investor protection lead to greater subsequent equity issues and a relaxation of capital constraints. Doidge (2004) finds that the voting premiums of firms with dual-class shares are considerably lower for cross-listed firms. Chung (2006) argues that investor protection also affects the liquidity of ADRs. Licht (2003), Siegel (2005), and Burns et al. (2007) challenge the legal bonding hypothesis for cross-listings in the US.

Bonding may also play a role for non-US exchanges, although to a lesser extent. Troeger (2007) argues that even informed investors do not assess individual rules and standards but only consider the general reputation of regulatory packages in their pricing. Hence, issuers can potentially capture a bonding premium when they list in any destination market with stricter legal investor protection than their home country.

3. Data and methodology

3.1. Sample description

We identify all cross-listings on eight major stock exchanges during the period 1982–2002. To be included in the sample, a company must have an identifiable listing date for a cross-listing