Does bonding really bond? Liability of foreignness and cross-listing of Chinese firms on international stock exchanges

Li Xian Liu\textsuperscript{a,}* , Fuming Jiang\textsuperscript{b} , Milind Sathye\textsuperscript{c}

\textsuperscript{a} Graduate School of Business, Curtin Business School, Curtin University, Australia
\textsuperscript{b} School of Management, Curtin Business School, Curtin University, Australia
\textsuperscript{c} Faculty of Business, Government and Law, University of Canberra, Australia

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ABSTRACT

This study examines the relationship between cross-listing and firm valuation in the context of Chinese firms cross-listed on major international exchanges, such as the NASDAQ, New York Stock Exchange (NYSE), Hong Kong Main Board, Hong Kong Growth Enterprise Market (GEM), Singapore Stock Exchange, and London Alternative Investment Market (LAIM). Through the lenses of bonding theory and liability of foreignness-based multinational enterprise theories, two sets of alternative hypotheses are developed and tested using panel data over a period of twelve years during 2001–2012. Contrary to the bonding theory, the results reveal that the firms listed in Mainland China recorded better valuation than the firms cross-listed on the international stock exchanges. The more sophisticated corporate governance mechanisms applied in international stock exchanges do not always entail better firm valuation. Institutional distance, cultural distance and the distance in economic freedom between China and the cross-listing location countries interact with governance variables negatively affecting performance of cross-listed firms. The direct negative impact of the three distance variables on the firm valuation is also statistically significant. The outcome of Chinese firms’ cross-listing behaviours appears to contradict the general bonding theory.

1. Introduction

The bonding hypothesis postulates that firms can encourage higher levels of protection for minority shareholder rights by cross-listing on a stock exchange that has a stronger, enforceable legal system (such as a U.S. stock exchange), and substitute these mechanisms for weak home country governance practices especially in emerging capital markets (Coffee, 1999, 2002; La Porta et al., 1997, 1998). Such cross-listed firms, it is envisaged would command higher firm value (Stulz, 1999). However, the hypothesis of the liability of foreignness asserts that cross-listing, instead of adding value may actually diminish it due to differences in institutions and cultures leading to additional costs (Bell et al., 2012; Licht, 2004). The cross-listed firms may also find themselves ill-equipped to conform to the stringent rules and sophisticated governance mechanisms in overseas stock exchanges. Chinese firms, especially for large state-owned enterprises (SOEs) are often beset with significant weakness in corporate governance mechanisms (Sun et al., 2006). These firms are relatively new players in both the international capital and product markets, and they still suffer from a lack of the international experience and managerial capabilities to integrate domestic and foreign operations and compete successfully in the unfamiliar foreign markets. These competitive disadvantage in international experience and managerial talent vis-à-vis their counterparts (especially developed country multinationals) impact on their ability to generate higher firm value (Rugman and Li, http://dx.doi.org/10.1016/j.ribaf.2017.04.033

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The above arguments lead to our central research question, that is: Can the bonding hypothesis adequately explain the relationship between firm value and cross-listing found in the literature in the Chinese context and if not what other factors impact such relationship? Accordingly, two alternative hypotheses are developed: (1) international cross-listing will yield a better valuation than Chinese firms listed only on the domestic stock exchange, or (2) international cross-listing will not necessarily outperform the Chinese firms listed only on the domestic stock exchange. To test the hypotheses we focus on firms that are listed on China A-share market and those that are listed both on China A-share market and one of the six international stock exchanges which include the New York Stock Exchange (NYSE), Hong Kong Main Board HKMB, Hong Kong Growth Enterprise Market (GEM), Singapore Stock Exchange SGX, and London Alternative Investment Market (LAIM). We analyse the panel data of Chinese cross-listings over a twelve-year period during 2001–2012. The findings suggest that (a) the Chinese cross-listing does not necessarily lead to a better firm valuation and (b) firm value was impacted by differences in corporate governance mechanisms across different international. Our findings are in line with prior studies. Siegel (2005) found that reputational bonding better explains the success of cross-listings as compared with legal bonding for Mexican firms. Sarkissian and Schill’s (2012) empirical study demonstrates the non-uniqueness of valuation premium for the US foreign listings. They show that the cross-sectional variation in the valuation premium has little association with such cross-country institutional features but is mostly related to variation in pre-listing valuation ratios. Busaba et al. (2015) show that Chinese companies previously listed abroad exhibit poorer post-issuance stock and operating performance in comparison to purely domestic issuers. Consequently, the extant bonding hypothesis cannot capture the relationship between cross-listing and firm value completely and requires a refinement. Besides the above findings, we contribute to the extant literature by developing such a refined bonding hypothesis.

2. Theory and hypothesis

2.1. Bonding theory and the Chinese context

Firms can encourage higher levels of protection for minority shareholder rights by cross-listing on a market that has a stronger, enforceable legal system (such as a U.S. stock exchange), thus substituting these mechanisms for weak home country institutions, especially emerging capital markets (Coffee, 1999, 2002; La Porta et al., 1997, 1998). This argument is known as the bonding hypothesis, and the central premise of the bonding hypothesis is rooted in accepted notions of good corporate governance (Jordan, 2006). Bonding is a practice enabled by globalization whereby firms seek listings on foreign exchanges that have high standards, it increases firm value as the firm's policies are more aligned so as to increase shareholder wealth and by making it easier for the firm to raise funds (Stulz, 1999). This argument was further elaborated by Coffee (1999, 2002) who referred to bonding as a mechanism by which firms incorporating in a jurisdiction with weak protection of minority rights or poor enforcement mechanisms can voluntarily subject themselves to higher disclosure standards and stricter enforcement to attract investors who would otherwise be reluctant to invest (or who would discount such stocks to reflect the risk of minority expropriation).

Given the above advantages of the bonding effect, cross-listing measures for improving the level of Chinese firms’ corporate governance practices have taken place at multiple levels. At the institutional level, China's legislative and administrative authorities, such as the China Securities Regulatory Commission (CSRC) and lawmakers, have stipulated more than 300 laws, regulations, rules, standards, and guidelines that form the basis of the legal framework on the securities and futures markets. The rules on information disclosure, accounting standards, and regulations for listed firms are strictly required to be followed. Auditing standards, the separation of certified public accountant (CPA) firms from the state system, internal control systems, and monitoring of related party transactions have been established. The roles of the board of directors, the supervisory committee, and the auditors in information disclosure have been identified (CSRC Report, 2000). At the firm level, Chinese firms have been and will continue to be engaged in listing their shares in foreign markets considered to have superior governance systems and in bonding to them by improving their internal corporate governance practices. These developments have produced some evidence of improved accounting conservatism, and investment efficiency for Chinese SOEs cross-listed on international exchanges (Hung et al., 2012).

However, the Chinese context presents a number of unique aspects of the Chinese firms. For instance, the controlling shareholders for most large Chinese firms are the state or the government, regardless of the firms’ listing locations, especially for SOEs. The main motivation of Chinese firms listing their shares in international stock markets does not seem to be in line with most of what has been revealed in the cross-listing literature (e.g. Amihud and Mendelson, 1986; Domowitz et al., 1998; Stapleton and Subrahmanyam, 1977). China's listed firms are not characterised by minority shareholder protections. More importantly, firms initially protect the interests of their insiders and majority shareholders (Li et al., 2008). Although the primary motivation of Chinese firms seeking overseas listing may not be to improve corporate governance, such cross-listing on an international stock exchange serves as a bonding mechanism for the firm's management to credibly commit to a better corporate governance regime. Thus improves firm performance, given that the Chinese firms are listed on the international stock exchanges have to comply with all the rules and regulations in the host markets.

2.2. Bonding hypothesis

When Chinese firms choose to list their shares internationally, regardless of whether they are SOEs or private firms, they are committed to a more rigorous disclosure standard and greater monitoring due to the host country’s laws and regulations, which “bonds” managers not to take excessive private benefits and reduces the expropriation of firm resources by controlling shareholders
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