

# SHORT-RUN PRICE PERFORMANCE OF IPOS AND CORPORATE GOVERNANCE PRACTICES: EVIDENCE FROM A FRONTIER MARKET

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## Abstract

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The short-run price performance of Initial Public Offerings (IPOs) indicates that the prices are often underpriced which is widely documented as a universal phenomenon. Corporate governance refers to the set of systems, principles and processes by which a company is governed. Establishing good corporate governance system in an IPO company makes good decisions which attract more outside investors. Therefore, this study examines whether there is any impact of corporate governance practices on short-run price performance of Sri Lankan IPOs. Study examined 44 fixed price IPOs which were listed on the Colombo Stock Exchange (CSE) during the period of 2003 - January to 2015- December. The study found that Sri Lankan IPOs underprice by 30% on AR, which is statistically significant at 5% level. Further, it found that block holder ownership (ownership concentration), CEO duality and existence of the non-executive directors in the board are positively related to the short-run underpricing, which are statistically significant at 5%. But, the board size has a significant negative impact on underpricing. These relationships are in line with the international literature which confirms that the corporate governance practices have significant impact on short-run price performance of IPOs in Sri Lanka. These findings also support the agency and signaling theories.

**Keywords:** Underpricing, Sri Lankan IPOs, Corporate Governance

## 1. INTRODUCTION

### 1.1. IPO – Initial Public Offerings

An initial public offering (IPO) is the first time that the stock of a private company is offered to the public. IPOs are often issued by smaller, younger companies seeking capital to expand, but they can also be done by large privately owned companies looking to become publicly traded.

Going to public by a company or initial public offering is the most critical stage of a firm. "Firms (to obtain) expanded access to equity capital allowing them to emerge and grow. (Fama & French, 2004). Further a firm's IPO does not only provide capital to the firm for its future expansion, but also provides the entrepreneurs associated with the firm their first substantive access to the cash rewards from their investment. Many scholars typically examined the determinants of the entrepreneurial firm's decision for going public. (Booth and Smith,

1986; Jain and Kini, 1999) further post IPO performance also examined. (Betty and Ritter, 1986; Brav, Geczy and Gompers, 2000; Espenlauch and Tonks, 1998; Michaely and Shaw, 1994). However, IPOs and corporate governance is examined less frequently but it is recognized as vital to any firm (Berton, Chahine and Filatotchev, 2009). In Sri Lankan context, the issue is not yet discussed widely.

### 1.2. Agency Theory

In large companies, there is a divorce between management and ownership. Shareholders as owners of a company are the principals and managers are their agents. Thus there is a principal agent relationship between shareholders and managers. (Pandey, 2010)

Agency theory will be the dominant theory associated with IPOs and corporate governance study (Beatty and Zajac, 1994; Brennan and Franks,

1997). Effective governance mechanisms will provide the important signals to investors that the risks associated with the agency issues are addressed in an effective manner. The analysis of IPO and corporate governance shall lead to analyze information asymmetries between the principals in the IPO firm and outside investors in the firm which can be lead to the reductions in the IPO performance (Certo, Daily Dolton, 2001; Michaely and Shaw, 1994).

### 1.3. Corporate Governance

The simplest and most concise definition of corporate governance was provided by the Cadbury Report in 1992, which stated: Corporate governance is the system by which companies are directed and controlled.

The Organization for Economic Co-operation and Development published its 'Principles of Corporate Governance' in 2004. These are:

- Rights of shareholders: The corporate governance framework should protect shareholders and facilitate their rights in the company. Companies should generate investment returns for the risk capital put up by the shareholders.

- Equitable treatment of shareholders: All shareholders should be treated equitably (fairly), including those who constitute a minority, individuals and foreign shareholders. Shareholders should have redress when their rights are contravened or where an individual shareholder or group of shareholders is oppressed by the majority.

- Stakeholders: The corporate governance framework should recognize the legal rights of stakeholders and facilitate cooperation with them in order to create wealth, employment and sustainable enterprises.

- Disclosure and transparency: Companies should make relevant, timely disclosures on matters affecting financial performance, management and ownership of the business.

- Board of directors: The board of directors should set the direction of the company and monitor management in order that the company will achieve its objectives. The corporate governance framework should underpin the board's accountability to the company and its members.

In this study several aspects of corporate governance are examined. Ownership concentration, directors' ownership, board size, non-executive directors, non-executive independent directors, CEO duality, family members in the board, directors' experience, and how these variables are affected to the underpricing of IPOs is studied.

## 2. REVIEW OF LITERATURE

Sandler & Weinstein (2012) found that the average board size of IPO firms was eight (8). The study had been done based on United States of America, 50 largest IPOs of 2009-2011. Further it was found that average independence of the board as 74%. And also only one third of the IPO companies had the CEO duality. Mak et al (2002) found that in relation to the Singapore market that board size is negatively associated with IPO pricing. Managerial ownership is positively related to pricing measures (offer

premium and market premium). Higher block holder ownership was positively related to offer premium.

One of the major indicator in relation with the firm's agency costs shall be controlled through the composition of the board (Filatotchev and Bishop, 2002). Investors shall concern on the board composition. The risk associated with the agency have been controlled successfully or not is their major concern before investing in an IPO firm will often seek to place people with specific characteristics and prestige on the board of the firm (Chen, Hambrick and Pollock, 2008). Jelic et al, (2005) stated that the possible impact of private equity on corporate governance and in turn on performance can also be seen. Further found that IPOs of private equity backed leveraged buyouts are more underpriced than those leveraged buyouts without private equity backing. But they perform better than their non-private equity backed counterparts in the long run in terms of stock market returns.

Wat (1983) stated that the founders of the company on the board of directors also send powerful signals to outside investors. Further founders of a firm are viewed by some outside investors as untested board members. However, Certo et al (2001) and Nelson (2003) found that for the one third to one half of IPO founders who lead to IPO firm and serve on the board, there are typically lower levels of perceived agency costs. As per Kunze (1990) and Vesper (1996), investors view the presence of a founder on the board very positively. Potentially there shall be a high level of ownership maintained by the founder and the splitting between principals or the owners and employees shall give a rise in agency cost. Further regarding founders; Beatty and Zajac (1994), Daily and Dalton (1997) and Finkelstein and D'Aveni (1994) stated that one aspect which is associated with founders on the board is that they hold both the CEO and Chairman of the boards, sometimes both positions simultaneously. Many scholars, this CEO duality problem has been considered more negatively. But surprisingly IPO researches provide more nuanced view on CEO duality. As per Filatotchev, Toms and Wright (2006), CEO board power may be beneficial for a firm at early stages of its development and during a strategic threshold such as an IPO. Chahine and Tohme (2009) and Nelson (2003) found that firms managed by founder CEO are likely to receive a higher percentage of price premium at the IPO.

When considering the ownership concentration, Jehnson and Meckling (1976) found that one result of concentrated ownership is a Jensen - Meckling type incentive alignment effect, which mitigates the post IPO risk of moral hazard. As per Loughran and Ritter (2004) while ownership by private equity investors are valued, potential conflicts of interest among pre-IPO investors can lead to higher underpricing.

## 3. METHODOLOGY

Through the numerous IPO research studies focused on short - run price performance and corporate governance in international financial markets, in Sri Lankan context which is known as frontier market is a complete dearth. Therefore, the objective of this study is to examine whether there is any impact of

corporate governance practices on short run performance of Sri Lankan IPOs.

### 3.1. Data and Sample

Study examined 44 fixed price IPOs which were listed on the Colombo Stock Exchange (CSE) during the period of 2003 - January to 2015 - December. This sample represents 88% of the total listed IPOs during this sample period.

### 3.2. Variables

Study measures the short-run price performance using the first listing day initial return (IR) and the impact of corporate governance practices on short-run price performance is identified using multiple regression models. Managerial ownership, block

holder ownership, board size, non-executive directors in the board, non-executive independent directors in the board, CEO duality, family members in the board, family members in the audit committee, non-executive directors in the audit committee, family members in the audit committee, family member as CEO, directors experience, audit opinion and auditors' reputation, were employed as independent variables to capture the governance impact. Further, controlling variables such as firm size, leverage, return on assets and asset tangibility were also used to understand the other impact. Initial return has been employed as the dependent variable. The independent variables were identified using prospectuses of IPOs. Figure 1 shows the conceptual framework and table 1 shows the variable definition.

Figure 1. Conceptual framework

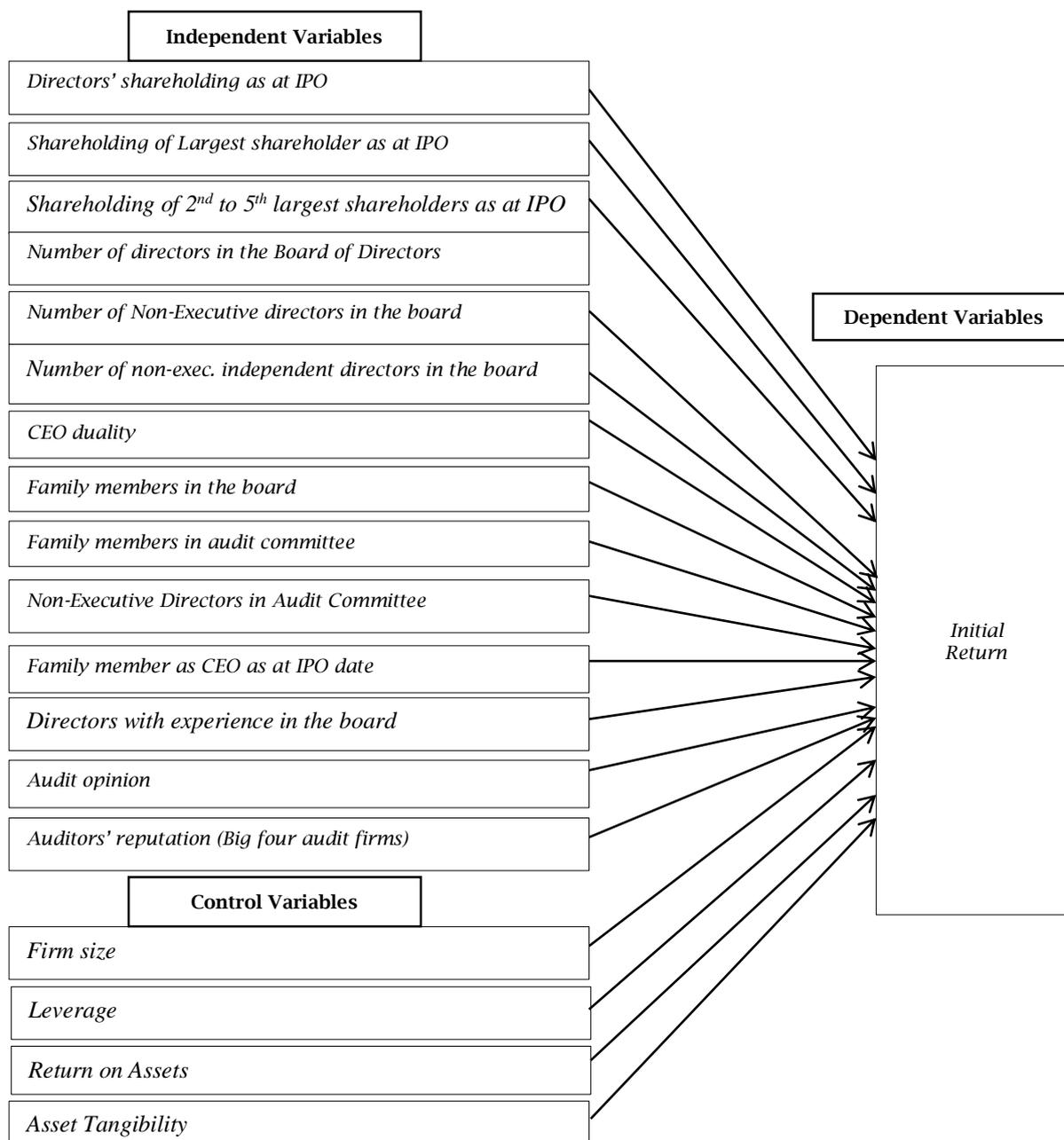


Table1. Variable Definition

Variable	Definition	Formula
DIRSH	Directors' shareholding as at IPO	$\frac{\text{Number of shares held by directors as at IPO}}{\text{number of shares as at IPO}}$
MSH	Shareholding of Largest shareholder as at IPO	$\frac{\text{Number of shares held by largest shareholder as at IPO}}{\text{number of shares as at IPO}}$
MSHTF	Shareholding of 2 <sup>nd</sup> to 5 <sup>th</sup> largest shareholders as at IPO	$\frac{\text{Number of shares held by 2nd to 5th largest shareholder as at IPO}}{\text{number of shares as at IPO}}$
BSize	Number of directors in the Board of Directors	$\frac{\text{Number of directors in the Board of Directors}}{\text{number of non executive directors}}$
NEX	Number of Non-Executive directors in the board	$\frac{\text{Board size}}{\text{number of non executive independent directors}}$
NEXIND	Number of non-executive independent directors in the board	$\frac{\text{Board size}}{\text{number of non executive independent directors}}$
CEOD	CEO duality	Dummy variable, if CEO= Chairman then value = 0 And if CEO ≠ Chairman, then Value = 1
FMBOD	Family members in the board	$\frac{\text{number of family directors}}{\text{Board size}}$
FMAC	Family members in audit committee	$\frac{\text{number of family members in audit committee}}{\text{Board size}}$
NEDAC	Non-Executive Directors in Audit Committee	$\frac{\text{number of non – executive directors in audit committee}}{\text{Board size}}$
FMCEO	Family member as CEO as at IPO date	Dummy, if yes then value = 1, if no, then value = 0
DIREXP	Directors with experience in the board	$\frac{\text{number of directors in the board holding other current directorships}}{\text{Board size}}$
AOP	Audit opinion	Dummy, if unqualified opinion, then value =1 Otherwise value= 0
BFA	Auditors' reputation (Big four audit firms)	Dummy, if the auditor of the company is one of big four firms (KPMG, E&Y,PWC, SJMS) , then Value=1, Otherwise value =0
FSize	Firm size	$\ln(\text{1st day closing price} * \text{size of IPO})$
LEV	Leverage	$\frac{\text{Total Liabilities}}{\text{Total Assets}}$
ROA	Return on Assets	$\frac{\text{Profit after tax}}{\text{Total Assets}}$
ATAN	Asset Tangibility	$\frac{\text{Non current assets}}{\text{total Assets}}$
<b>Dependent Variable</b>		
IR	Initial Return	$\ln \left[ \frac{\text{1st day closing price}}{\text{offer price}} \right]$

### 3.3. Model

The regression model is as follow:

$$IR = \beta_0 + \beta_1 DIRSH + \beta_2 MSH + \beta_3 MSHTF + \beta_4 BSize + \beta_5 NEX + \beta_6 NEXIND + \beta_7 CEOD + \beta_8 FMBOD + \beta_9 FMAC + \beta_{10} NEDAC + \beta_{11} FMCEO + \beta_{12} DIREXP + \beta_{13} AOP + \beta_{14} BFA + \beta_{15} FSize + \beta_{16} LEV + \beta_{17} ROA + \beta_{18} ATAN + \varepsilon \quad 3.1$$

Dependent variable of the model, Initial Return (IR) is measured by taking the natural logarithm (ln) of first day closing price divided by the offer price of IPO. Directors' shareholding as at IPO (DIRSH) is measured by the number of shares held by directors as at IPO (IPO date) divided by the number of shares of the company as at IPO date. To measure the ownership concentration, shareholding of largest shareholder and 2<sup>nd</sup> to 5<sup>th</sup> largest shareholders' percentages are taken in to consideration (MSH and MSHTF). Board size (BSize) is taken as the number of the directors in the board. Number of non-executive directors (NEX) and number of Non-Executive independent directors in the board (NEXIND) has been taken as a fraction of the board size. A dummy variable is included to denote the CEO Duality (CEOD), values are assigned "0" and "1" to denote CEO and Chairman Posts are held by one person and CEO and Chairman Posts are held by two persons respectively. To measure the family involvement to the company, family members in the board (FMBOD) and the family members in the audit committee (FMAC) are taken into consideration as a fraction of board size. To measure the independency of the audit committee, number of non-executive directors

in the audit committee (NEDAC) has been employed as a fraction of board size. Dummy variable is included to denote the family control as CEO (FMCEO), which is denoted by 1, if family member is CEO and 0 if not. To measure the experience effect of the directors, directors with the experience in the board (DIREXP) is included in the model as a fraction of board size. Experience is measured by the number of directors of the IPO company who are having directorships in any other companies divided by board size. Effect of Audit Opinion (AOP) on the underpricing is included in the model by taking the audit opinion given by the auditors on the latest financial statements included in the prospectus. Measurement is taken as a dummy variable which is denoted by 1 and 0, if unqualified and qualified respectively.

Another dummy variable is introduced to the model to check whether there is any impact of auditors' reputation (BFA) on the underpricing of IPO. If the auditors of the latest financial statements published in the prospectus are coming under the big four audit firms, namely, KPMG, E & Y, PWC and SJMS, then value is assigned as 1 and otherwise 0 is assigned. Firm size (FSize), Leverage (LEV), Return on

Assets (ROA) and Assets Tangibility (ATAN) are utilized as control variables in the model which are used in previous literature as well.

#### 4. ANALYSIS

##### 4.1. Descriptive statistics (Table 4.1.1)

Mean initial return of the sample was 30% which means Sri Lankan IPOs are underpriced by 30% on initial return. Directors' shareholding percentage was 13.7% means directors' shareholding as at IPO in Sri Lankan context is at a considerably lower level. On average 74.5% of the shares before IPO is owned by one shareholder of the company and from the balance shares, 18.4% is owned by the 2<sup>nd</sup> to 5<sup>th</sup> largest shareholders' of the company. It can be observed that there is a higher ownership concentration in relation to the Sri Lankan IPOs.

Surprisingly mean board size as at IPO date in Sri Lankan IPOs were 7 with a maximum of 11 and minimum of 5. Further 66% of the board is comprised with non-executive directors and 31% of the board is comprised with one-executive independent directors as at IPO date which may lead to a higher independency of the board. Interestingly CEO duality of Sri Lankan IPO firms was 72% means majority of the IPO firms are employing two

separate persons for CEO and Chairman posts, which leads to greater level of corporate governance,

Further 14.5% of the board size comprised with family members in the IPO companies, which means at a considerably lower level. On the other hand, in the audit committee there were only 2.7% family members which leads to a greater independency of the audit committee of the IPO Companies. Further audit committee of an IPO company, 36% is comprised with non-executive directors with a maximum and minimum of 67% and 33% respectively.

When considering the CEO position, 27% of IPO companies appointed a family member as CEO which means appointing a family member as CEO in Sri Lankan IPO companies is less than 30% which means considerably lower value. 95% of the directors in the board of IPO companies are with experience, which leads to an efficient and effective control of the company and also it may give a positive signal to the investor about the company regarding their risk of investment in the IPO company and it may mitigate the risk in the investors point of view. Surprisingly, 86% of the IPO companies were with unquoted audit opinion for their latest financial statements which are published in the prospectus and also 81% of the IPO companies employed one of the big four audit firms as their auditors, which means almost all IPO companies may tend to appoint a well reputed auditor when they are very closer to IPO.

Table 4.1.1. Part 1 - Descriptive Statistics

	<i>IR</i>	<i>DIRSH</i>	<i>MSH</i>	<i>MSHTF</i>	<i>BSIZE</i>	<i>NEX</i>	<i>NEXIND</i>
Mean	0.308683	0.137268	0.745897	0.184033	7.636364	0.661065	0.313118
Median	0.214265	8.80E-05	0.77945	0.11615	7	0.683333	0.309524
Maximum	1.94591	1	1	0.67105	11	0.857143	0.6
Minimum	-0.33821	0	0.22175	0	5	0.333333	0
Std. Dev.	0.475146	0.281403	0.24874	0.199499	1.865615	0.168635	0.171377
Skewness	1.833835	1.985287	-0.56036	0.852102	0.276176	-0.54894	-0.36089
Kurtosis	7.461958	5.64465	2.150851	2.668449	1.676654	2.015916	2.528063
Jarque-Bera	30.5808	20.863	1.812291	2.76305	1.884976	1.992621	0.681704
Probability	0	0.000029	0.404079	0.251195	0.389657	0.369239	0.711164
Sum	6.791025	3.019896	16.40973	4.048727	336	14.54343	6.8886
Sum Sq. Dev.	4.741037	1.662938	1.299305	0.835799	73.09091	0.59719	0.616774
Observations	44	44	44	44	44	44	44

Table 4.1.1. Part 2 - Descriptive Statistics

	<i>CEOD</i>	<i>FBOD</i>	<i>FMAC</i>	<i>NEDAC</i>	<i>FMCEO</i>	<i>DIREXP</i>	<i>AOP</i>	<i>BFA</i>
Mean	0.727273	0.144936	0.027273	0.3618	0.272727	0.950866	0.863636	0.818182
Median	1	0	0	0.333333	0	1	1	1
Maximum	1	0.6	0.2	0.666667	1	1	1	1
Minimum	0	0	0	0	0	0.714286	0	0
Std. Dev.	0.455842	0.193099	0.07025	0.170516	0.455842	0.097184	0.35125	0.394771
Skewness	-1.02062	0.854778	2.119252	0.070925	1.020621	-1.61143	-2.11925	-1.64992
Kurtosis	2.041667	2.395819	5.491228	2.520846	2.041667	3.998852	5.491228	3.722222
Jarque-Bera	4.661314	3.013645	22.15687	0.228901	4.661314	10.43587	22.15687	10.45962
Probability	0.097232	0.221613	0.000015	0.891856	0.097232	0.005419	0.000015	0.005355
Sum	32	3.1886	0.6	7.959596	12	20.91905	38	36
Sum Sq. Dev.	4.363636	0.783032	0.103636	0.610592	4.363636	0.19834	2.590909	3.272727
Observations	44	44	44	44	44	44	44	44

Table 4.1.1. Part 3 - Descriptive Statistics

	<i>FSIZE</i>	<i>LEV</i>	<i>ROA</i>	<i>ATAN</i>
Mean	20.35094	0.486628	0.070796	0.503236
Median	20.27979	0.548698	0.05577	0.630554
Maximum	23.09211	0.916908	0.289723	0.970604
Minimum	17.95865	0.005403	-0.01662	0.006661
Std. Dev.	1.167229	0.285604	0.0702	0.310557
Skewness	0.322619	-0.23266	1.621321	-0.44977

	<i>FSIZE</i>	<i>LEV</i>	<i>ROA</i>	<i>ATAN</i>
Kurtosis	3.73022	1.954128	5.893789	1.947483
Jarque-Bera	0.870424	1.20117	17.31468	1.757208
Probability	0.647127	0.548491	0.000174	0.415362
Sum	447.7207	10.70581	1.557514	11.07119
Sum Sq. Dev.	28.61088	1.712957	0.103488	2.025364
Observations	44	44	44	44

#### 4.2. Regression results (Table 4.2.1)

When considering the regression results, ownership concentration (MSH and MSHTF) has a significant positive impact on underpricing of IPOs. Largest shareholding and second to fifth largest shareholding percentage is significant at 5% level. Board size of the IPO firm has a significant impact on IPO underpricing and statistically significant at 5% level. Appearance of the non-executive directors (NONEX) in the board has a positive significant impact on the IPO underpricing. However non-executive independent directors' appearance does not make any significant impact on the underpricing of Sri Lankan IPOs.

CEO duality (CEOD) has a positive significant impact on underpricing and it is significant at 1% level, which means CEO duality has a greater impact on IPO underpricing. Surprisingly, family members' involvement gives contrast results. A family member in the board has a negative significant impact whereas family a member in the audit committee gives a positive significant impact, which may be investigated further in the future, researches. Further existence of non-executive directors in the audit committee gives a negative significant impact on the underpricing. Appointing a family member as CEO of the company gives a positive significant impact on IPO underpricing which means potential investors may have a positive view on appointing a family member as CEO.

Directors' experience (DIREXP) has a positive significant impact (at 10% level) on underpricing means potential investors may positively view regarding the existence of well experience directors in the board. When considering the audit opinion (AOP), it has a negative significant impact on the IPO underpricing. However, if the auditor of the IPO firm is one of the big four audit firms (BFA), it has a positive significant impact on underpricing of IPO means auditor's reputation is also become a significant factor.

Not surprisingly, all control variables are statistically significant in the model at 5% level. Adjusted R squared value of the model is .63 means 63% of the variance of the initial return or underpricing is explained by the above variables of the model. F statistics also significant at 10% level means overall model can be considered as statistically significant at 10% level.

#### 4.3. Autocorrelation

The Durbin Watson statistic is a number that tests for autocorrelation in the residuals from a statistical regression analysis. The Durbin-Watson statistic is always between 0 and 4. A value around 2 means there is no autocorrelation in the sample. Values approaching 0 indicate positive autocorrelation and values toward 4 indicate negative autocorrelation. Durbin Watson stat for this model is 2.48 means more closely to 2, which indicates that there is no autocorrelation in the sample.

Table 4.2.1. Regression Results

Dependent Variable: IR				
Method: Least Squares				
Sample: 44				
Included observations: 44				
<i>Variable</i>	<i>Coefficient</i>	<i>Std. Error</i>	<i>t-Statistic</i>	<i>Prob.</i>
C	-12.36579	3.072928	-4.024105	0.0276
DIRSH	-0.498139	0.525767	-0.947451	0.4133
MSH	8.477969	1.725858	4.91232	0.0162
MSHTF	7.386275	1.683349	4.387844	0.0219
BSIZE	-1.515723	0.240959	-6.290366	0.0081
NEX	2.323652	0.709725	3.274019	0.0466
NEXIND	0.211831	0.44677	0.474139	0.6678
CEOD	2.240791	0.273912	8.180686	0.0038
FMBOD	-8.276729	2.023177	-4.090957	0.0264
FMAC	8.885042	2.707788	3.281291	0.0464
NEDAC	-23.52372	3.594402	-6.544542	0.0073
FMCEO	3.77173	0.936036	4.02947	0.0275
DIREXP	2.34922	0.922053	2.547814	0.0841
AOP	-1.292566	0.259274	-4.985336	0.0155
BFA	1.021281	0.313753	3.255051	0.0473
FSIZE	1.17839	0.229151	5.142414	0.0142
LEV	-4.604931	1.294979	-3.555988	0.0379
ROA	4.736451	1.039566	4.556183	0.0198
ATAN	-4.345837	1.156825	-3.756694	0.033
R-squared	0.776675	Mean dependent var		0.308683
Adjusted R-squared	0.636727	S.D. dependent var		0.475146
S.E. of regression	0.191993	Akaike info criterion		-0.727876
Sum squared resid	0.110584	Schwarz criterion		0.214387
Log likelihood	27.00664	Hannan-Quinn criter.		-0.505907
F-statistic	6.978815	Durbin-Watson stat		2.488392
Prob(F-statistic)	0.067361			

## CONCLUSION

IPO can be viewed as a turning point of a private equity firm which will be converted to a public company. It is important to have corporate governance practices in IPO companies. Having corporate governance practices in an IPO company will have an impact on potential investor's decisions. Corporate governance practices in Sri Lankan IPO companies are becoming an essential factor. One of the major findings regarding Sri Lankan IPO companies is the board size. Sandler and Weinstein (2012) found that average board size of IPO firms was 8 on a research based on USA and Mak et al (2002) found that there was a negative relationship with IPO pricing in Sri Lankan Context. Board size average is found as 7 and negative relationship is observed which is in line with the international

literature. Further it was found that, CEO duality has a positive significant impact on underpricing, which means CEO duality has a greater impact on IPO underpricing. Another interesting finding was that the ownership concentration has a positive impact on underpricing. Appointing a family member as CEO of the company gives a positive significant impact on IPO underpricing which means potential investors may have a positive view on appointing a family member as CEO in Sri Lankan Context. Existence of the non-executive directors in the board is positively related to the short-run underpricing. These relationships are in line with the international literature, which confirms that the corporate governance practices have significant impact on short-run price performance of IPOs in Sri Lanka. These findings also support the agency and signaling theories.

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