

**BOARD STRUCTURE AS A SIGNALING PROXY OF IPO QUALITY:
A STUDY ON BURSA MALAYSIA SECOND BOARD FIRMS**

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Struktur Lembaga sebagai Proxi Isyarat Kualiti IPO:

Kajian atas Firma Bursa Malaysia Papan Kedua

ABSTRAK

Fenomena terkurang harga sejak dahulu lagi menambak perhatian para akademik dalam usaha mereka untuk merasionalkan kejadian anomali ini. Kajian mengenai hubungan antara tadbir urus korporat dan prestasi firma juga sering di kaji. Certo, Daily dan Dalton (2001) ialah para akademik pertama yang mengabungkan kedua bidang ini dengan melihat pada struktur lembaga sebagai proksi isyarat kualiti firma pada masa Tawaran Awam Permulaan.(IPO). Sekata dengan teori isyarat, keputusan kajian mereka mendapati saiz lembaga dan reputasi lembaga mempunyai korelasi negatif dengan terkurang harga; tetapi komposisi lembaga dan struktur kepimpinan lembaga tidak mempunyai korelasi negatif dengan terkurang harga. Kajian ini memperluaskan siasatan mereka kepada IPO di Bursa Malaysia Papan Kedua untuk mencari kesan isyarat yang ditemui oleh mereka. Kajian ini menggunakan 114 sampel IPO bagi tempoh 2001 hingga 2007. Penemuan kajian mendapati tiada sokongan empirikal untuk menunjukkan struktur lembaga boleh memberi isyarat kualiti firma jesterunya mengurangkan tahap terkurang harga. Walau bagaimanapun, kajian ini mendapati bahawa tahap terkurang harga bagi firma di Papan Kedua untuk tahun 2001-2007 bila diukur dengan pulangan permulaan diperlaraskan dengan nilai pasaran telah berkurangan dengan banyak (purata 21.37%) berbanding dengan kajian pada IPO Papan Kedua terdahulu (purata 101.57%) oleh How, Jelic, Saadouni dan Verheoeven (2006) bagi tempoh 1989-2000.

Board Structure as a Signaling Proxy of IPO Quality:

A Study on Bursa Malaysia Second Board Firms

ABSTRACT

The IPO underpricing phenomenon has long fascinated academicians in the effort of finding the rational for the anomaly. Similarly, the relationship of corporate governance with firm performance is often investigated. Certo, Daily and Dalton (2001) are the first to combine these two areas of researches by exploring on the board structure as the signaling proxy for firm quality during initial public offering (IPO). Consistent with the signaling theory, their results show that board size and board reputation are inversely correlated with IPO underpricing; but board composition and board leadership structure are not inversely correlated with IPO underpricing. This study extends their research to Bursa Malaysia Second Board IPOs in an effort of finding the shown signaling effect. A total of 114 IPO sample firms for period of 2001 to 2007 were included in this study. The findings however found no empirical support that board structure plays a role in signaling firm value thus reduces underpricing. However, this study found that the level of underpricing for the Second Board over the 2001-2007 period as measured by market adjusted initial return had reduced substantially (average 21.37%) as compared to earlier Second Board study (average 101.57%) of How, Jelic, Saadouni and Verheoeven (2006) for the period of 1989-2000.

Chapter 1

INTRODUCTION

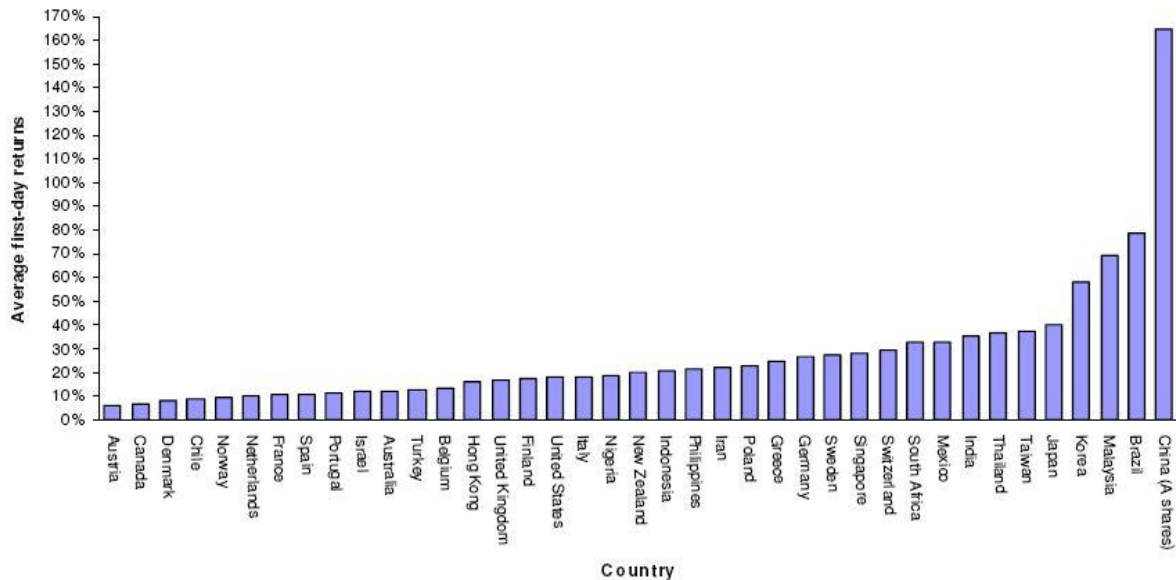
1.1 Introduction

An Initial Public Offerings (IPO) is the first sale of shares by a firm to the public investors. IPO brings benefits to the issuing firm by opening access to pool of fund for financing future growth at lower cost and to bring good publicity, which in essence may bring in more business or draw better pool of human capital. As documented in a lot of prior empirical studies globally, the offer price of IPO has been generally underpriced providing a positive abnormal initial return on the initial trading days – an initial underpricing phenomenon. This study will add to the existing IPO literature on initial underpricing anomaly investigating on the board structure role in signaling firm value which can reduce underpricing.

1.2 Background of the Study

The act of “leaving the money on the table” by the issuing firm rather than capturing the full amount available when there is no underpricing puzzles the academicians. Ritter and Welch report that the average first-trading-day return to be 18.8% for 6,249 US IPOs between 1980 and 2001 inclusive (cited in Varshney & Robinson, 2004, p. 56) On top of that, the level of initial underpricing or the “discount amount” varies over time and varies from market to market. As shown in Figure 1.1 below, the initial underpricing is evident in many countries.

Average first-day returns on IPOs



Average initial returns (offer price to first closing market price unaffected by price limits) for 39 countries. The sample periods and the number of IPOs differs from country to country, and are described in the accompanying table (<http://bear.cba.ufl.edu/ritter/pbritter.htm>). Data come from a variety of studies by various authors. This is an updated version of the information contained in the 1994 *Pacific-Basin Finance Journal* article by Tim Loughran, Jay Ritter, and Kristian Rydqvist. Updated October 2007.

Figure 1.1. Average first-day returns on IPOs (Ritter, 2007).

Malaysian IPOs which are not spared from this underpricing phenomenon suffered a deeper level of underpricing than US IPOs. In fact, Malaysian IPOs underpricing is one of the highest observed. Yong (2007, p. 254) in his review of Asian IPOs mentions that the average initial return for Malaysian IPOs as "...Loughran et al. (1994) - 80.3% for Malaysia Ritter (2003) - 104.1% for Malaysia".

Why does the issuing firm willing to underprice the firm rather than capturing the full amount should there is no underpricing? Why does underpricing vary from market to market? Why does underpricing changes over time? Due to these questions remain largely unexplained, this underpricing phenomenon continues to fascinate the academicians and inspires a large amount of literature in attempt of rationalizing the reason for underpricing. Ljungqvist (2006) generalizes the theories of underpricing documented in the IPO literature

into: (1) asymmetric information, (2) institutional reasons, (3) control considerations and (4) behavioural approaches.

Of these, models based on asymmetric information are very much established. Asymmetric information models assume one of parties involved in the issuing of IPO which consist of the issuing firm, the underwriter, and investors knows more than the others. The signaling theory advocates the firm knows better on the true intrinsic value of the firm, thus uses underpricing as a signaling proxy of the firm high-quality to attract investors who at this point are not knowledgeable on the firm. The incentive behind this act of deliberately leaving plentiful of money on the table is to gain lasting favourable impression among the investor community through a “good-choice” experience. Thereafter, the high-quality firm is able to offer subsequent offerings at a higher price thus enable it to recoup the earlier “loss”.

Signaling by underpricing is often challenged by alternative signaling proxies of firm quality. Advocates for the alternative signaling proxy reason that the alternative signaling proxy allows the firm to get similar required effect while not bearing the “loss” from intentionally underprice the IPO. The alternative proxies frequently used thus far are for example the certification effect from reputable underwriters, reputable auditors and backing by venture capitalist.

1.3 Problem Statement

Malaysian IPOs are not spared from this underpricing phenomenon, in fact the level of underpricing is more severe than those observed elsewhere. Yong (2007) in his review of Asian IPOs mentions that the average initial return for Malaysian IPOs as “...Loughran et al. (1994) - 80.3% for Malaysia Ritter (2003) - 104.1% for Malaysia” (p. 254). Yong further documents that IPOs listed on Malaysian Second Board which consists of smaller and

less profitable firms generally underprice more than those in Main Board. In fact, this contributes to usage of listing board as a proxy for firm-quality by Taufil Mohd (2007).

Certo, Daily and Dalton (2001) explore on the board structure as the signaling proxy for firm quality during IPO, extending the earlier researches which have concentrated on studying the relationships of corporate governance with firm post IPO-performance. Their empirical result demonstrated that board size and board reputation coincide with the signaling theory while board independence does not.

After the Asian financial crisis in 1997, the effectiveness of corporate governance in Malaysia is questioned. This gives rise to the establishment of the non-profit organization, Malaysian Institute of Corporate Governance (MICG) in 1998 with its mandate to raise awareness and practice of good corporate governance in Malaysia. Subsequently Malaysian Code on Corporate Governance in 2000 was created to serve as the guiding principles and best practises for corporate governance in Malaysia. As such, this study is proposed as it is interesting to check whether corporate governance practice for Malaysian firms can have similar signaling effect for the firm quality at IPO stage.

In particular, this study will extend Certo et al (2001) research to Malaysia with the aim to investigate the certification effect of the board structure in signaling firm quality to potential IPO investors, which helps to reduce the initial underpricing. The scope of study is limited to IPOs listed on the Bursa Malaysia Second Board. The Bursa Malaysia Second Board (previously known as KLSE Second Board) is the avenue for Small and Medium Enterprises (SMEs) to raise capital fund. As these firms are deemed younger and smaller and potentially attract more non-institutional investors due to being affordable; it is motivating to find out whether board structure is able to certify the firm value.

1.4 Research Objectives

This study seeks to study the certification effect of the board structure on the IPO firm quality which reduces initial underpricing.

1.5 Research Questions

This study attempts to answer the following questions:

- 1 For younger IPO firms seeking listing in Second Board, which elements of the board structure are able to certify firm value which thus reduces the underpricing?
- 2 Which of the existing known factors are able to explain the underpricing?
- 3 Does the level of underpricing remain constant or change with time?

1.6 Definition of Key Terms

In this study, the key terms are defined as follows:

- 1 Underpricing refers to the positive abnormal market adjusted initial return frequently seen in an IPO. Any negative return (overpricing) will also be referred to underpricing unless it required to be differentiated.
- 2 Board structure refers to following elements which are the independent variables for this study: (1) board size (2) board composition (3) board leadership (4) board reputation.
- 3 Board size refers to the total number of members in the board of directors of the IPO firm.
- 4 Board composition refers to the proportion of independent directors to the total number of members in the board of directors of the IPO firm.

- 5 Board leadership refers to separation roles of the board chairman and the highest executive ranking leadership. Separate board leadership essentially means the board chairman is not the Chief Executive Officer (CEO) or Group Managing Director (MD).
- 6 Board reputation refers to the independent directors' reputation as measured by total additional public directorships held by the independent directors. A highly reputable independent director puts their reputation at stake together with the other executive directors. Therefore, a bad decision made by the team would tarnish the independent reputation which would then reduce the likelihood for the independent director to be invited to sit on other firms' board.
- 7 An independent director is a board member that has no professional or personal stake in the IPO firm so that the director may make sound judgement in the best interest for the firm, minority shareholders and other stakeholders.

1.7 Significance of the Study

This study has contributions in the following area:

- 1 Expands the existing literature on IPO research in Malaysia to study whether board structure signals firm quality which thus reduces underpricing.
- 2 Shifts the focus to Bursa Malaysia Second Board IPOs which are less studied and where the results will benefit the retail investors as these IPOs are more affordable.
- 3 Calculates the initial underpricing which is adjusted to market return instead of using the raw underpricing commonly used in Malaysian IPO literature.

1.8 Organization of Remaining Chapters

This study will focus on investigating the impact of quality and reputation of the firm's board of directors towards IPO underpricing. The literature review on IPO underpricing, theoretical framework and the hypotheses for this study are discussed in Chapter 2. Chapter 3 is on the methodology and on how this study is conducted. The results of the study are found in Chapter 4. Finally in Chapter 5, interpretation and the implication of the results as well as the limitation and future direction of study are discussed.

Chapter 2

LITERATURE REVIEW

2.1 Introduction

This chapter begins with a brief description of the underpricing phenomenon, showing evidence of initial underpricing and the various measurements of initial underpricing. This is followed by a literature on IPO initial underpricing based on asymmetric information models, in particular, the Rock's Winner Curse and Signaling Models. The next section describes corporate governance focusing on those aspects that are related to this study and some other literature on corporate governance relating to firm performance. The Malaysian Second Board IPOs section covers the Malaysian underpricing phenomenon, on Second Board IPOs and corporate governance. This following section describes the theoretical framework on the use of board structure in signaling firm quality. The chapter ends with a discussion on the hypotheses for this study.

2.2 Underpricing Phenomenon

Three most important anomalies are documented in the IPO literatures – (1) initial or short-term underpricing phenomenon, (2) “hot issue” market phenomenon and (3) the long-run underperformance anomalies. All these aspects were subjected to rigorous research especially in the United States (US) (Yi, 2003; Varshney & Robinson, 2004). The level of initial underpricing varies over time and varies from market to market. This variation interests researchers and inspires a number of theories to rationalize the phenomenon. Ljungqvist (2006)

generalizes these theories into: (1) asymmetric information, (2) institutional reasons, (3) control considerations and (4) behavioural approaches.

In the Asian markets, deeper level of initial underpricing is uncovered. Some other variables which are unique to Asian IPOs are studied in effort to explain the deeper level of underpricing observed. Meanwhile, examination on the long-run performance reveal overperformance which is inconsistent with the underperformance result observed in US IPOs (Yong, 2007). This study will further extend the underpricing phenomenon to Malaysian Second Board IPOs.

2.2.1 Measurement of Initial Underpricing

Initial return is most commonly measured as the percentage difference between the IPO offer price and the price at the end of the first trading day or listing day. This initial return may be positive or negative where the positive return corresponds to underpricing, a term frequently used in the IPO literature, while the negative return denotes the offer price is overpriced. The existing IPO literature on underpricing frequently use the term “underpricing” to denote the initial return regardless of whether it is positive or negative. Hence, to conform to existing literature, this study will use the term “underpricing” in place of initial return, ignoring its sign.

The measurement mentioned above is the raw underpricing which is commonly used in well-developed markets like US and increasingly the European markets where the market fluctuation between the offer price and the IPO first day closing price is typically negligible as the offer price is set merely hours or few days prior to trading. Similarly, underpricing may be measured as the price difference of aftermarket trading price and offer price multiplied by the number of shares available for the IPO subscription. This measurement takes into account the

actual monetary value resulted from underpricing the offering or generally known as “money left on the table”.

Market adjusted initial return measures underpricing as the difference between initial return and the market return. This measurement should be used instead of the raw underpricing measurement especially when studies are focused on the emerging markets where the offer date and listing date differs substantially. This measurement is used in Kiyamaz (2000), Ghosh (2004) and How, Jelic, Saadouni and Verheoeven (2006) studies.

Another type of measurement which looks into a longer window period may be used if the market is limited by maximum daily volatility. For example, instead of using the listing date closing price; the end-of-week closing price may be used to account for the delayed equilibrium effect.

In Malaysia, the IPO is normally offered on average one month before the debut listing. Therefore, the measurement of the initial underpricing which is the dependent variable in this study is based on the market-adjusted initial underpricing to take into account the waiting period between offer date and the listing date.

2.3 Underpricing Models - Asymmetric Information

The key parties involved in the IPO process are the issuing firm, the underwriters and the investors who purchase the IPO shares. Asymmetric information models assume that one of the parties has more knowledge than the others – an existence of information friction. By far, the most established models in IPO literature are based on asymmetric information.

The best description of the information friction is Rock’s Winner Curse (cited in Ljungqvist, 2006, p.11) which is elaborated below. The Signaling model which is the heart of this study is elaborated as well. However, there are other theories on asymmetric information

which are not discussed: (1) the information revelation theories which assume investors have more information that need to be elicited; and (2) principal-agent models which regard the underwriters have the upper hand and may create agency problem to the issuer.

2.3.1 The Winner's Curse

As cited in Ljungqvist (2006, p.11), Rock's Winner Curse assumes that some investors have the upper hand in the information possession, that is, they are better informed than the other investors. Uninformed investors face the Winner's Curse as they indiscriminately bid for the IPOs: whereby they will receive all biddings for the unattractive IPO shares. In the case of attractive IPOs, their bidding is partly crowded by the informed investors' bidding. If the uninformed investors frequently receive overpriced IPOs and suffer losses, they will gradually remove themselves from IPO market. Rock assumes the IPO market requires the continuous participation of the uninformed investors as demand from the informed investors only is insufficient. Hence, to ensure that the IPO market has the participation of all investors, IPO firms are coerced into underpricing.

According to Ljungqvist (2006), the implications from this Winner's Curse are: (1) adjusted for rationing, uninformed investors' return is zero to ensure continuous participations, while informed investors' earn the informed conditional return; (2) underpricing is lower if information is distributed more evenly among investor groups; (3) underpricing is expected to be higher the greater the ex ante uncertainty of firm value; (4) underwriter market share depends on whether or not the underwriter coerced the firm into "fair" underpricing; and (5) reducing information asymmetry between informed and uninformed investors can reduce underpricing.

2.3.2 Signaling Model

In the signaling model, information asymmetry exists as it is assumed that the issuing firm possesses the insider information about the firm's present risk value and the prospects for growth of the firm. According to the signaling theory, the firm may try various mechanisms to signal the firm high value, where the signal used must be: (1) obvious and be made known in advance which allows the investors to be timely informed and to effectively utilize the signal; and (2) either costly or difficult to imitate to ward of low-quality firm from imitating.

Allen and Faulhaber, Grinblatt and Hwang, and Welch contribute theories related to issuing firm deliberately underprice the IPO offer price as a signal of firm value (cited in Ljungqvist, 2006, p. 36). Discounting the offer price is a costly approach but it allows the issuing firm to return to the market with an image of a high-value firm and reap the earlier loss in subsequent more successful issues. Low-quality firms refrain from following the high-quality firms as their true low-value are often revealed before the next offerings, which means they are not able to recoup the cost of underpricing at later issues.

However, using underpricing as proxy for firm high-value is challenged by alternative signaling proxies suggested by other studies. These other signaling proxies, if successful in certifying firm high-value are negatively correlated with underpricing. These proxies include for example, the use of reputable underwriters (e.g., Chemmanur & Fulghieri, 1994; Logue, Roglaski, Seward, & Forster-Johnson, 2002), reputable auditors (eg. Balvers, McDonald, & Miller, 1988; Menon & Williams, 1991), venture capitalists (Chemmanur & Loutskina, 2006; Megginson & Weiss, 1991), the board of directors structure (Certo et al., 2001) and the quality of the top management (Chemmanur & Paeglis, 2005; Hesjedal, 2007).

2.4 Corporate Governance

Corporate governance is determined by the set of relationships between a firm's management, its board of directors, its shareholders and other stakeholders. Corporate governance provides the structure affecting the way a firm is directed, administered or controlled through the set of processes, customs, policies, laws and institution. This allows the firm to set objectives, the means of attaining the objectives and monitoring the performance; while the board of directors acts as the execution mechanism of corporate governance. In essence, corporate governance mitigate agency problem by providing proper incentives for the board of directors and the management of the firm to pursue objectives that are in the good interests of the firm, shareholders and other stakeholders while using the resources efficiently.

Of late, corporate governance regulation receives a lot of attention especially after the Asian Financial Crisis, and then the various high profile corporate scandals such as Enron and Worldcom. US Sarbanes-Oxley Act of 2002 is enacted in response to the various infamous corporate scandals.

In the Malaysian context, Malaysian Institute of Corporate Governance (MICG) is established in 1998 which has the mandate to raise awareness and practice of good corporate governance in Malaysia. This is followed by the creation of Malaysian Code on Corporate Governance in 2000 which serves as the guiding principles and best practises for corporate governance in Malaysia. The code is accompanied by Bursa Malaysia listing requirement to disclose the firm's extent of applying the principles and best practices in its annual reports.

2.4.1 Board of Directors and Responsibilities

In most public firms, the board is composed of a chairman who is the leader of the board; executive directors who are the management in the firm or the insiders; independent directors

who are hired from outside and have no personal or professional stake in the firm; and sometimes non-executive directors who are not the management in the firm but have personal stake in the firm or are representatives from firms who have stake in the said firm.

These hired board members or directors are generally responsible for: (1) reviewing and adopting strategic plan (2) overseeing the conduct of the firm and ensuring it is properly managed (3) identifying risks and ensuring implementation of risk management (4) reviewing adequacy and integrity of the firm's internal control system and management information system (5) ensuring existence of succession planning and (6) developing and implementing an investor relation programme for effective communication on the firm activities to the firm external investors ("Listing Requirement of Bursa Malaysia Securities Berhad", 2006).

The Executive Directors are responsible for determining and implementing operational decisions, whilst the Non-Executive Directors complement with their skills and experiences. Meanwhile, the Independent Non-Executive Directors play a crucial role in ensuring that the strategies proposed by the management are fully deliberated and examined. In summary, the major role of the board of directors is to protect the shareholders' interest; or in essence, is the ultimate governing body within the management structure of the publicly traded firm.

2.4.2 Corporate Governance and Firm Performance

Corporate governance has long been a subject of study as it is believed that a well-governed firm has better firm performance. There are many studies in the relationship between corporate governance variables and various firm performances such as Tobin Q, operating performance and shareholder payout. For example, Baysinger and Butler (1985) showed that there is a positive correlation between board composition and firm performance measured a decade after IPO. Similarly, Barnhart, Marr and Rosenstein (1994) showed board composition has a positive relationship with market-to-book value. However, Bhagat and

Black (1999, 2001) do not found support for the expected positive correlation between board composition and firm performance. Daily and Dalton (1994) reported firm bankruptcy has positive relationship with board independence which is measured as interaction of board composition and board leadership.

Certo et al (2001) is the first study to use IPO underpricing as a measurement for firm performance and relate it to corporate governance. IPO underpricing is used as a performance measurement as at the stage of IPO it is the most immediate available measurement of firm performance. Their study is focused on the relationship between IPO performance and board structure which is an essential component of corporate governance that is easily observable. Relying on signaling theory which was elaborated in Section 2.3.2, they investigated on whether board structure can be used as an alternative proxy to signal firm quality. An inverse relationship between board structure and IPO underpricing is expected if board structure does signal firm quality. Details on usage of board structure in signaling firm value thus reducing underpricing is found in Section 2.6.

2.5 Bursa Malaysia Second Board IPOs

In Malaysia, public firms can get listed in Bursa Malaysia on the Main Board, Second Board or MESDAQ. Firms seeking listing in the Main Board is subjected to very high and stringent entry requirements. Hence the Main Board is dominated by highly-capitalised firms – the “blue chips” that are attractive to foreign and institutional investments. The Second Board is a secondary market created in November 1988 with the objective to provide an avenue for SMEs to raise capital funds. This indirectly allows wealth accumulation among the Malaysian public as they are able to invest in these firms at cheaper prices compared to pricey “blue chips” firms. The MESDAQ Board which started operation in 2002 is to essentially

create a fund-raising market for technology firms or high-growth firms with little or no track record (U.S. PECC FMD Committee, 2001).

2.5.1 Literature on Factors Influencing Underpricing

The literature on Malaysian IPOs is not as excessive as the literature done for US IPOs. This provides a lot of opportunities to test the various theories which have been empirically tested using US IPOs. Nevertheless, the Malaysian IPO literature documents some IPO underpricing factors which are unique to Malaysian IPOs.

The implication of Rock's Winner Curse model where higher underpricing is expected to compensate for the firm risk is supported by US IPOs. Using firm age as the proxy for the risk; Hiau Abdullah and Taufil Mohd (2004) and Jelic, Saadouni and Briston (2001) do not find evidence supporting the positive relationship between underpricing and risk for Malaysian IPOs. Similarly, How et al. (2006) using firm age and growth option as proxy for risk do not find a conclusive positive relationship between risk and underpricing.

Larger firms are able to bear the cost of underpricing will be able to underprice more in accordance to the signaling model. Studies on Malaysian IPOs find support for this relationship (Hiau Abdullah & Taufil Modh, 2004; Wan-Hussin, 2005, 2006). However, Yong and Isa find that Second Board IPOs which are smaller in size than IPOs listed in Main Board have relatively a higher level of underpricing (cited in Yong, 2007, p. 260).

According to signaling theory, underwriter reputation can signal firm high-value thus reducing underpricing. However, contradicting the results shown in US IPOs, Jelic et al. (2001) found that prestigious underwriter on average underprices the share.

Subscription rate or demand highly influence the level of underpricing as found by Yong and Isa (cited in Yong, 2007, p. 260) and Wan-Hussin (2006, 2005). High demand reflects high level of interest of investors to obtain the IPO shares thus leading to the belief of firm

high value. This creates market sentiment to bid up the IPO trading price or “hot issue” causing higher underpricing.

Wan-Hussin (2006, 2005) finds that the existence of share moratorium or share lockup is a determinant of underpricing level. Bursa Malaysia regulates a share moratorium on most of the IPO firms, requiring a 45% lockup of the outstanding shares belonging to the substantial shareholders’ shares within one year of listing. Thereafter, these shares maybe liquidated on a straight-line basis over a 3-year period. This share moratorium regulation replaces the IPO profit guarantee scheme. Both schemes serve the same purpose of protecting the shareholders investment and have a positive association with underpricing. In fact, his study shows that the greater the level of directors’ shares subjected to lockup, the higher the level of underpricing. This also implies that the level of retained ownerships is highly correlated to underpricing.

Using 70 IPOs listed in Malaysia between 1991 and 1998, Hiau Abdullah and Taufil Mohd. (2004) explore on another regulator intervention which is the indigenous or “bumiputera” population share allocation. As a mechanism to redistribute wealth, the Malaysian government requires at least 30% indigenous population ownership for firms seeking listing. Their empirical result supports the positive relationship between the indigenous ownership and underpricing. Their underpricing model uses firm size, number of shares held by substantial shareholders after IPO, indigenous population ownership, and substantial shareholder’s loss due to offering their pre-IPO shares as explanatory variables.

2.5.1 Corporate Governance and Second Board

As part of the effort to raise awareness and practice of good corporate governance in Malaysia, the Malaysian Code on Corporate Governance 2000 was applied to Malaysian firms using a hybrid of perspective approach and non-perspective approach. The Code consists of broad principles which allow for flexibility in applications, by factoring in circumstances and

common sense. The non-perspective approach regulates of the extent of practices to be disclosed in the annual reports of public firms. The principles and best practices stated in the Code cover areas of the Board of Directors; Directors' remuneration; Shareholders; and Accountability and Audit.

Although the Code serves as guiding principles and best practices, some of them are made mandatory as part of the listing requirement under Chapter 15: Corporate Governance. For example, Bursa Malaysia requires a Board to have independent directors, the number of whom must be higher than 2 or 1/3 of the total board members. A director may only hold up to 10 directorships in listed firms and 15 directorships in other firms. ("Listing Requirement of Bursa Malaysia Securities Berhad", 2006)

Second Board IPOs are the focus of this study. According to the Bursa listing requirement, firms seeking listing in the Second Board must have an issued and paid up capital of at least RM 40 million with an operating history of at least five full financial years. Within the operating period, the firm needs to demonstrate an uninterrupted profit record of 3 to 5 years, with an aggregate after-tax profit of RM 12 million, of which, the most recent year must have a profit of RM 4 million. ("Listing Requirement of Bursa Malaysia Securities Berhad", 2006)

Second Board firms are relatively younger firms dominated by family-owned business which have smaller capital when compared to their "blue chips" counterparts on the Main Board. They are also subjected to less restrictive listing requirements and are yet to build reputation among the investors. All these give the perception of "lower quality" and are then less attractive to institutional investors.

The insiders or top executives are the main contributors for the firm success enabling the firms to fulfil the listing requirements. As such, high asymmetric information between insiders and investors is expected for the Second Board IPOs. Therefore, these firms provide a

fertile ground for testing theories based on asymmetric information specifically signaling theory which assumes the issuing firms or insiders know better on the firm. However, using underpricing as signaling proxy is not cost effective for these small-capital firms. This allows investigation using alternative signaling mechanism such as board structure.

2.6 Theoretical Framework

This study is inspired by the work by Certo et al. (2001) which examines board structure as a signal for firm high value thus reducing underpricing. Essentially, this study extends their study to Malaysian IPOs on Bursa Malaysia Second Board.

As noted by Certo et al. (2001), using board structure as the proxy in signaling firm quality fulfils the criteria for a signaling proxy mentioned earlier which are (1) obvious/earlier known and (2) costly/difficult to impersonate. The first criterion is fulfilled as the information of the board of directors is readily available from the IPO prospectus where there is a section detailing the directors' profile. The IPO prospectus is an essential document to the listing process and acts as the key source of information for investors. The second criteria is fulfilled as independent directors who put their reputation on the line will be hesitant to be involved in any decision that would jeopardize their reputation, that is joining a low-quality Board. Hence, low-quality firms would not be able to get prestigious independent directors on the Board.

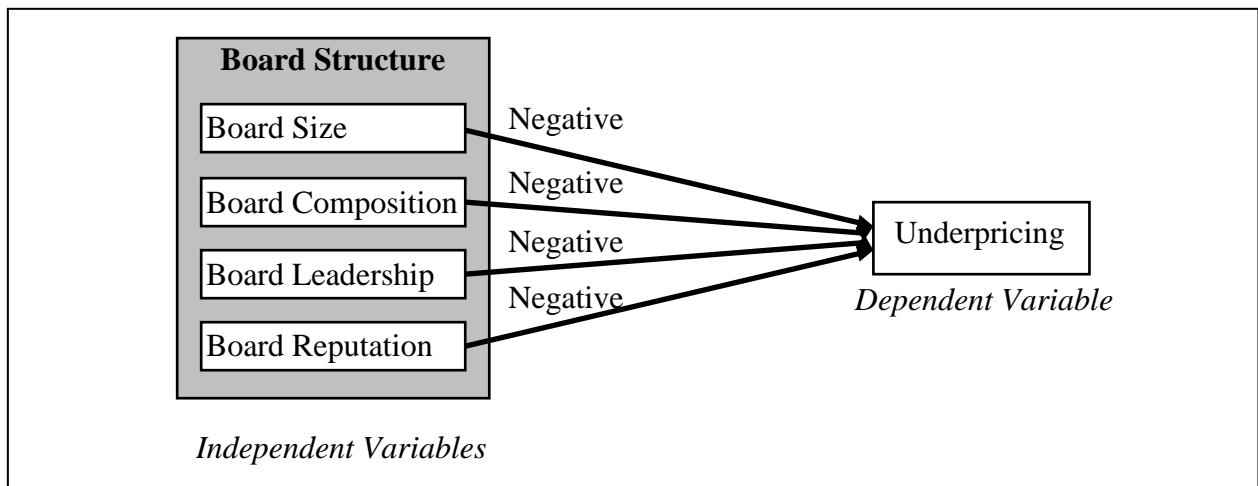


Figure 2.2. Theoretical framework.

The theoretical framework shown in the diagram above follows the study by Certo et al. (2001). The independent variables and the hypotheses relating them to underpricing are elaborated in the following section.

2.7 Hypotheses

This section covers the independent variables and the associated hypotheses in the theoretical framework mentioned in the earlier section.

2.7.1 Board Size

Board size is the total number of members sitting on the board. As cited in Certo et al. (2001, pg. 38), there is no agreement in existing literature on a “good” size is. Some studies for example, Yermack say large is better but some say less is better for example Alexander, Fennel and Halpern; and Dalton, Daily, Johnson and Ellstrand. Advocates of larger board size argue that smaller firms will benefit more with larger board size as it represents the possibility of accessing to a wider range of external resources important to the firm. The Malaysian Code of Corporate Governance does not state a size or size range but requires the firm to evaluate the size based on the impact to effectiveness.

Following Certo et al (2001) which relies on the argument that at the stage of IPO, greater access to external resources is crucial, it is hypothesized that:

H1: Board size will be negatively related to underpricing

They found support for this hypothesis from their empirical result.

2.7.2 Board Independence

Board independence reflects how autonomous the board may function as the corporate governance body in relation to management ranks decisions for the firm. As noted by Filatotchev and Bishop (2002, pg. 945), corporate governance literature frequently measures board independence as the proportion of independent directors or board composition and board leadership structure.

The Bursa Malaysia listing requirement defines independent director as someone "... who is independent of management and free from any business or other relationship which could interfere with the exercise of independent judgement or the ability to act in the best interests of an applicant or a listed issuer ..." in section 1.01. Furthermore, it requires a board composition of at least of 2 independent directors or 1/3 of the board size to consist of independent directors. ("Listing Requirement of Bursa Malaysia Securities Berhad", 2006). As for board leadership structure, the Malaysian Code of Corporate Governance does not encourage combining the role of the board Chairman and Chief Executive Officer (CEO) and requires public disclosure explaining the decision if the roles are combined. ("Malaysian Code on Corporate Governance March 2000", 2000)

A more independent board encourages effectiveness leading to better governance due to no dominance of the executive directors, and a well-governed firm leads to better performance. Earlier literature however did not find conclusive support. Those that supported the argument are for example, Baysinger and Butler (1985) which shows that there is a positive correlation

of board composition with firm long run performance measured by a decade after inception. Barnhart, Marr and Rosenstein (1994) study reveals similar correlation when using market-to-book value as firm performance measurement. Daily and Dalton (1994) study on firm bankruptcy finds support for positive relation with board independence measured as interaction of board composition and board leadership. However, a later study by Bhagat and Black (1999, 2001) does not support the positive correlation of board composition and firm performance.

Certo et al. (2001) study the relationship of board independence with firm performance at IPO stage. They measure board independence in two separate variables which are board composition and board leadership. Their study which relies on signaling theory predicts both variables to have an inverse relationship with underpricing. The hypotheses which follow Certo et al (2001) study will be tested:

H2: Independent directors will be negatively associated to underpricing

H3: Separate board leadership will be negatively related to underpricing

However, it is noted that Certo et al (2001) result shows that the higher number of independent directors, the greater the level of IPO underpricing which rejects hypothesis H2. They also do not find support for hypothesis H3. They explain that this reflects underwriters' belief that growth-oriented firms are better served by insider directors who are more familiar with the firm than outside independent directors.

2.7.3 Board Reputation

Reputation plays an important role in the corporate world because good reputation works like a charm to influence favourable decisions, whether it is for investment, career or product choices. This is especially true if the decision has to be made in an environment where information is scarce and the uncertainty of return is high. In fact, the IPO underpricing

literature on asymmetric information has suggested using reputation as signaling mechanism of firm value, for example, using reputable underwriter and reputable auditor.

Recognizing the importance of reputation, people or firms alike work hard to establish their reputation. Independent directors build their reputation by enriching their skills, gaining invaluable experience and building connectivity. These reputable independent directors are highly sought after, especially by firms wishing to “rent” their reputation to signal the firm value. However, reputation is fragile as it takes a lot of effort to build it but takes very little to tarnish it. Any bad decision that the board make will easily tarnish the hard-earned reputation of independent directors causing them to be careful in selecting which board to sit in.

Relying on signaling theory, Certo et al. (2001) found evidence that existence of reputable independent directors measured by number of additional directorships held by the independent director is able reduce the asymmetric information thus reduces underpricing. Following Certo et al. (2001), it is hypothesized that:

H4a: Board reputation will be negatively related to underpricing

Based on earlier literature such as Shivdasam, and Cohen and Cohen (cited in Certo et al., 2001, p. 38), Certo et al. (2001) investigated on existence of a non-linear relationship between board reputation and IPO underpricing. This hypothesis relates to the argument that beyond a certain threshold, additional directorships jeopardize the effectiveness of the director. In other words, board reputation will reduce underpricing but at a decreasing rate. Therefore, this non-linear relationship was measured as squared value of additional directorships held by the independent director. Consistent with H4a, the non-linear relationship is expected to have inverse relationship with underpricing. However, the non-linear relationship expected is not apparent in their empirical result.

H4b: Board reputation relationship with underpricing will be non-linear

Bursa listing requirement on corporate governance seems to agree with the effectiveness argument on number of directorships. As part of the listing requirement, a limit of 25 directorships that a director may hold at any one time is set, 10 of which can be for listed firms. (“Listing Requirement of Bursa Malaysia Securities Berhad”, 2006)

2.8 Summary

This study is a first attempt to examine the impact of corporate governance on IPO initial performance. As the study is focused on Malaysian Second Board IPOs, the results from this study will benefit retail investors in their investment decisions.