Lower restrictions for start-ups to list on stock exchanges have mixed results

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Firms can finance their activities by selling their stocks in public equity markets, thus becoming public companies. An initial public offering (IPO) is the first time a company issues stocks to raise capital. In general, since these companies have limited access to external finance, it is expected that raising capital through an IPO will help them invest in growth opportunities. Not all private firms, however, are allowed to go public — only those that meet the listing requirements related to size, age and profitability.

So, what happens when a stock exchange relaxes the listing requirements? There are two contrasting predictions. One is that lowering requirements will enable small firms that have higher growth potential to go public, which will stimulate economic growth. The second, contrasting, prediction is that lower requirements will enable low-quality firms to go public. In this case, providing capital for them is an inefficient way to invest money.

Policymakers sometimes bet on the first prediction. They expect that relaxing listing requirements, or creating new stock exchanges with lower listing standards, will help firms with high-growth potential but that do not meet stringent listing requirements. The idea is that these companies will have opportunities to raise capital and grow after the IPOs. Several stock exchanges in the world are creating new markets for start-ups. In the UK, for example, the Alternative Investment Market (AIM) was established in 1995 as an alternative to the Unlisted Securities Market (USM). In China, the Shenzhen Stock Exchange created an emerging market for start-ups in 2009 called Venture Board.

The relationship between relaxing listing requirements and IPO firm growth is still unclear, and so our research uses a Japanese dataset to look at what happens after relaxing the listing requirements and creating new markets. There are two reasons for using the Japanese data. First, Japan experienced deregulation of the IPO market in the late 1990s, relaxing the listing requirements and allowing new stock markets for start-ups. Second, our Japanese dataset covers the financial information of not only public but also private companies. This longitudinal dataset enables us to investigate the effects of environmental change on the performance of IPO firms and to compare their performance to both public and private firms.

We then set out to compare the growth of IPO firms to that of public and private firms with similar characteristics — such as present profitability, growth opportunity and firm size, among others. We collect data from the IPO firms in both periods: stringent requirement and low requirement.

In addition, we measure 'excess growth' to control for macro-economic conditions that have changed over time and the characteristics of IPO firms that differ from those of non-IPO firms. As proxies for a firm's growth, we use three types of measures: productivity, profitability and firm size (in terms of sales and number of employees).

The results show that firms listed in the **post-deregulation period** have greater variability in profitability and productivity growth. These two measures grow faster before, when they are still private. This suggests that relaxing listing requirements enables not only low-quality firms but also potentially growing firms to go public. However, the growth rate falls after a firm goes public, suggesting that going public harms the strength of an IPO firm.

In contrast to the growth of productivity and profitability, we find that firm size (i.e. sales and employment) in the post-deregulation period grows more both before and after the IPO than in the pre-deregulation period. Our results suggest that although productivity and profitability of firms decrease after the IPOs, IPOs contribute to job creation (i.e., contribution to employment generation).

Although newly established markets or the relaxing of listing standards of stock markets are expected to stimulate the economy by enabling small firms to access the public market, our study shows that the influence is limited. What do policymakers who expect that deregulation will help firms grow through an IPO think? However, this is a matter not only for policymakers but also for entrepreneurs. They are required to think about growth both before and *after* their IPOs.

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Notes:

- *This article is based on the authors' paper IPOs, growth, and the impact of relaxing listing requirements, published in the Journal of Banking & Finance, Volume 59, October 2015, Pages 505–519.*
- *This post gives the views of the authors, and not the position of LSE Business Review or the London School of Economics.*
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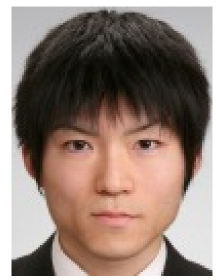
Hidenori Takahashi is Research Fellow at Graduate School of Business Administration, Kobe University, Japan. His papers have been published in journals such as the Journal of Banking & Finance and Journal of Corporate Finance.



Kazuo Yamada is an Associate Professor of Finance at Nagasaki University, Japan. His research interests include corporate finance, cash policy, and entrepreneur finance. His papers have been published in journals such as the Journal of Business Finance & Accounting and Journal of Banking & Finance.