Corporate Governance in IPO firms
Other titles in Annals of Corporate Governance

*The Political and Governance Risks of Sovereign Wealth*
Paul Rose
ISBN: 978-1-68083-624-0

*A Framework for Examining the Heterogeneous Opportunities of Value Creation in Private Equity Buyouts*
Francesco Castellaneta, Simon Hannus and Mike Wright

*The Norwegian Gender Balance Law: A Reform that Failed?*
R. Oystein Strom

*The Neglected Role of Justification under Uncertainty in Corporate Governance and Finance*
Claire A. Hill and Alessio M. Pacces

*Governance Complexities in Firms with Dual Class Shares*
Anita Anand
ISBN: 978-1-68083-4

*How Reported Board Independence Overstates Actual Board Independence in Family Firms: A Methodological Concern*
Iram Fatima Ansari, Marc Goergen and Svetlana Mira
ISBN: 978-1-68083-404-8

*Governance of Hybrid Organizations*
Jeffrey J. Reuer and Elko Klijn
Annals of Corporate Governance

Published, sold and distributed by:
now Publishers Inc.
PO Box 1024
Hanover, MA 02339
United States
Tel. +1-781-985-4510
www.nowpublishers.com
sales@nowpublishers.com

Outside North America:
now Publishers Inc.
PO Box 179
2600 AD Delft
The Netherlands
Tel. +31-6-51115274

The preferred citation for this publication is

ISBN: 978-1-68083-635-6
© 2020 E. E Lehmann and S. Vismara

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, mechanical, photocopying, recording or otherwise, without prior written permission of the publishers.

Photocopying. In the USA: This journal is registered at the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923. Authorization to photocopy items for internal or personal use, or the internal or personal use of specific clients, is granted by now Publishers Inc for users registered with the Copyright Clearance Center (CCC). The ‘services’ for users can be found on the internet at: www.copyright.com

For those organizations that have been granted a photocopy license, a separate system of payment has been arranged. Authorization does not extend to other kinds of copying, such as that for general distribution, for advertising or promotional purposes, for creating new collective works, or for resale. In the rest of the world: Permission to photocopy must be obtained from the copyright owner. Please apply to now Publishers Inc., PO Box 1024, Hanover, MA 02339, USA; Tel. +1 781 871 0245; www.nowpublishers.com; sales@nowpublishers.com

now Publishers Inc. has an exclusive license to publish this material worldwide. Permission to use this content must be obtained from the copyright license holder. Please apply to now Publishers, PO Box 179, 2600 AD Delft, The Netherlands, www.nowpublishers.com; e-mail: sales@nowpublishers.com

Full text available at: http://dx.doi.org/10.1561/109.00000012
Annals of Corporate Governance
Volume 5, Issue 1, 2020

Editorial Board

Editor-in-Chief
Douglas Cumming
York University
Canada

Associate Editors
Renee Adams
University of New South Wales

Lucian Bebchuk
(Hebrew University)

William Judge
Old Dominion University

Mark Roe
(Hebrew University)

Rene Stulz
Ohio State University

James Westphal
University of Michigan

Full text available at: http://dx.doi.org/10.1561/109.00000012
Editorial Scope

Topics

Annals of Corporate Governance publishes articles in the following topics:

- Boards of Directors
- Ownership
- National Corporate Governance Mechanisms
- Comparative Corporate Governance Systems
- Self Governance
- Teaching Corporate Governance

Information for Librarians

Annals of Corporate Governance, 2020, Volume 5, 4 issues. ISSN paper version 2381-6724. ISSN online version 2381-6732. Also available as a combined paper and online subscription.
## Contents

1 **Introduction** 2
   1.1 A brief survey of investment decisions and IPOs 4

2 **The trajectory of the literature on corporate governance** 7
   2.1 Features that make IPOs of interest for corporate governance 11
   2.2 Comparative evidence: Shareholder and Stakeholder Societies 15

3 **Mechanisms in Corporate Governance of IPO firms** 17
   3.1 Market mechanisms and the role of competition 18
   3.2 Authority and Institutional Mechanisms: Exit and voice 22
   3.3 Board of Directors 23

4 **Financial investors and the capital structure of IPO firms** 47
   4.1 Banks 49
   4.2 Venture Capitalists 51

5 **Empirical evidence: IPO Performance** 55
   5.1 IPO Underpricing 57
   5.2 Valuation 58
   5.3 New venture growth 60
   5.4 Failure and survival 61
   5.5 IPOs and M&As 63

Full text available at: http://dx.doi.org/10.1561/109.00000012
Corporate Governance in IPO firms

Erik E. Lehmann¹ and Silvio Vismara²,³

¹Chair of Management and Organization, Universität Augsburg, Germany, Universitätsstr. 16, D-86159 Augsburg; erik.lehmann@wiwi.uni-augsburg.de
²Department of Management, Information and Production Engineering, University of Bergamo, Italy, viale Marconi 5, 24044 Dalmine (BG), Italy; silvio.vismara@unibg.it
³Department of Accountancy and Corporate Finance, Ghent University, Belgium, Sint-Pietersplein 7 9000 Gent, Belgium; vismara.silvio@ugent.be

ABSTRACT

An Initial Public Offering (IPO) is a crucial stage in the life of a firm since it allows the firm to emerge and grow. Corporate Governance, intended as the set of mechanisms and institutional designs that ensure that investors get a return on their investment, is a key aspect in the IPO since it ultimately affects its performance as well as the valuation given by the market. In this manuscript, we review the trajectory of the literature on corporate governance using a theoretical framework that distinguishes corporate governance mechanisms from market, authority and institutional mechanisms.
Traditionally, studies in corporate governance focus on the “Berle- Means-Corporations”, which are large companies where the separation of (disperse) ownership and control gives power to managers. While this has advanced our understanding of how large firms are and should be governed, less research analyzes the ‘Big Bang’, the point in time when the separation of dispersed ownership and control occurred: the initial public offering (IPO). With the emergence of new firm creation in the high-technology industry at the beginning of the 1980s, the phenomenon of the IPO has been increasing interest in the management and finance literature. Empirical studies have investigated the determinants of the decision to go public (Booth and Smith, 1986), underpricing and post-issue performance (Beatty and Ritter, 1986), or long-term performance (Ritter 1991; Signori and Vismara, 2018b). Research in the corporate governance of IPO firms was thus mainly concerned about information asymmetry and the agency costs created between the insiders of the IPO team, the underwriters, and public market investors (Certo et al., 2001) and how and why these agency costs shape IPO performance (Ljungqvist, 2007). Despite the numerous studies focusing on specific aspects of IPOs in general, there is little systematic research on corporate
governance mechanisms at work of a firm at the IPO stage (an exception is Filatotchev and Allcock, 2013). A few surveys on corporate governance consider the specific role of IPO firms, analyzing governance issues in entrepreneurial firms (Audretsch and Lehmann, 2014), in high-tech firms (Bertoni et al. 2013), or in newly listed companies (Audretsch and Lehmann, 2013). Exceptions are Filatotchev and Allcock (2013), surveying the interrelationships between corporate governance issues on IPO performance, focusing in particular on the role of boards and executive remuneration, as in the edited volume by Levis and Vismara (2013). The papers included highlight different aspects of IPO firms, ranging from pre- to post IPO performance, the role of underwriters and venture capitalists, short and long-run performance studies, as well as country-specific aspects.

Corporate governance mechanisms in IPO firms, however, differ from the traditional corporate governance issues in several ways. First, an IPO confronts the founder-manager of the firm with the trade-off between obtaining additional resources to sustain future growth and profits and maintaining total control of the company. Secondly, this constitutes a trade-off for investors between the expected returns of a risky investment and the agency costs associated with moral hazard and adverse selection effects caused by imperfect and asymmetric information. Thirdly, analyzing IPOs offers insights into how these agency costs are priced by investors at the point in time that these costs occur. Fourthly, of difference is which governance mechanisms are at work at this initial stage of a company’s lifecycle. Finally, analyzing corporate governance issues in IPO’s offers additional insights on the macro level and reveals country-specific differences.

Corporate governance of IPO firms encompasses theories and concepts analyzing, judging and describing financial decisions in entrepreneurial firms and draws on positive and normative aspects of entrepreneurship. In a positive way, this essay describes these phenomena in aspects of governance issues in IPO firms, and why and how governance structures shape the behavior, the boundaries and the performance of these firms. In a normative way, this essay offers concepts on how institutions and mechanisms should be designed and
work to optimize a respective goal or performance associated with the IPO of an entrepreneurial firm. In an attempt to overcome the segmentation of the literature (Cumming and Vismara, 2017), our review of the literature encompasses articles published in different fields, such as finance, economics, entrepreneurship, and management.

1.1 A brief survey of investment decisions and IPOs

Even if corporate governance issues in IPO firms have been in the focus of academia more than just recently, investment decisions of entrepreneurs have been in the center of theory building for more than a century. Shaped by the IPO waves in the late 19th century, investment decisions of firms and the decision to go public has become a major topic in economic theory.

In neoclassical theory, the theory of IPOs begins with the individual consumer. Consumers have preferences over consumption bundles, initial endowments of factors of production and of goods and services. They can act as producers and operate manufacturing technology, either individually or collectively (see Spulber, 2009, p. 2). If profit opportunities constitute the purpose of entrepreneurial action, consumers are able to set up and manage organizations acting like an entrepreneurial consumer. (Arrow and Hahn, 1971) make the point that making production decisions distinguishes the entrepreneur from the consumer. An entrepreneur makes efforts and investments to create a firm, with the aim to receive returns to ownership.

One of the first who introduced investment decisions and corporate governance issues in entrepreneurial firms is Fisher (1930). He distinguishes the investment decisions of a company from its owners’ saving objectives. The optimal investment decisions at a firm-level are therefore independent of how the investment is financed, either by debt or equity and independent of the owner’s preferences. The owners of a firm are only affected by the decisions through their wealth. The separation of investment from consumption decisions implies that the firm’s objective is nothing else than profit maximization. With the separation of objectives, the owners can allocate some of the decisions to managers. Fisher (1930)’s famous work opened the discussion for
1.1. A brief survey of investment decisions and IPOs

corporate governance issues in IPOs in two ways. First, he pointed out that the capital structure of the firm is irrelevant; therefore, an IPO is an equivalent alternative to debt and bank financing. Second, he opened the discussion on the separation of ownership and control made popular a few years later by Berle and Means (1932).

Concerning the first argument, we could argue why we should care about a firm’s financial structure. A first and simple answer is, as Tirole (2006, p. 77) ironically points it out, if a firm’s financial structure, and in particular the event of an IPO, is irrelevant, why then should insiders, like owner-managers and the top management team, as well as outsiders like commercial banks, investment banks, venture capitalists and other equity holders, devote such a lot of intention to its design? According to the famous Modigliani-Miller Theorem (Modigliani and Miller, 1958), under some conditions, the total value of the firm is independent of the financial structure. Decisions concerning the financial structure affect only how the statistical distribution of income that the firm generates is shared, but the distribution itself has no effect on the size of the firm.

Some years later, Jensen and Meckling (1976) showed in their semi-formal model that the Modigliani-Miller theorem does not hold in markets where complete and perfect information are not costless: a firm’s capital structure is not ‘irrelevant’ (see Tirole, 2006, p.77/78), or, in other words, the choice between debt and equity becomes a decision variable, shaped by the costs and benefits for both, the owner-manager and the investor (Audretsch and Lehmann, 2004), leading to the well-known pecking-order behavior (Myers and Majluf, 1984). Due to moral hazard and adverse selection effects, debt financing high-risk projects leads to the problem of credit rationing (Stiglitz and Weiß, 1981). This leads to prohibitively high costs of debt financing, altering the opportunity costs of equity financing with the above-cited trade-off between obtaining additional resources to finance future investments. Consequently, literature recognized that the initial public offering (IPO) is an important stage in the life cycle of entrepreneurial firms and one of the first challenges of its entrepreneurial phase, entering the growth stage (Filatotchev and Allcock, p. 421). An IPO, “is the point of entry
that gives firms expanded access to equity capital, allowing them to emerge and grow” (Fama and French, 2004, p. 229).

Several stages of equity financing have thus been discussed in the literature (see Tirole, 2006, p. 82). In the first stage, equity is held by one (or several) entrepreneurial founders. In a second stage, these founders may raise additional equity from a small number of investors (friends & family, business angels, or venture capitalists among others) through a private placement (see Block et al. (2019) for a comparison of private equity investment criteria). A small number of firms then enter the third stage and go public in an initial public offering. The fourth stage could then be a secondary or seasoned public offering (which is not subject to this essay).
References


References


Full text available at: http://dx.doi.org/10.1561/109.00000012
References


Full text available at: http://dx.doi.org/10.1561/109.00000012
References


References


References


References


References


