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The Relationship Between Corporate Governance and Underpricing: A Case Study in Ho Chi Minh Stock Exchange*

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Abstract

Underpricing signifies that IPO share prices do not reflect the fundamental value of the listed company. Corporate governance plays an essential role in IPOs where the board of directors, the independent board of directors, and the board of supervisors are significant elements of accurate share pricing. The study investigates the underpricing phenomena and short-term performance of the IPO companies during the listing process in the Ho Chi Minh Stock Exchange (HOSE). The work outcomes illustrate the role of the corporate organizational structure in the period of the IPO process that may attract potential investors. The hypothesis testing is conducted with a multiple regression model including 100 observations from enterprises doing IPO listed on HOSE. The study results generate signals for the investors and regulators that the board of directors holds a strong negative influence on the underpricing process. Secondly, the level of the independent board of directors and stock exchange in itself has no significant impact on the underpricing process. Underpricing is one of the many anomalies of the stock exchanges that provide wrong signals for the market participants. Identifying stock prices that reflect their intrinsic value is an ongoing debate among scholars, investors, and other market participants.

Keywords: Corporate Governance, Initial Public Offering (IPO), Underpricing

JEL Classification Code: G10, G11, G12, G18

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1. Introduction

For many reasons, the pricing of goods and services is a complex affair. Demand uncertainty and information asymmetry heightened the complexity of this task much further. The pricing of initial public offerings (IPOs) also does not escape from this fact. IPO is a practice of issuing and selling new equity by a firm on the public stock market for the first time. While the main reason for going to the public is raising capital to the firm and creating the opportunity for existing shareholders to convert some of their wealth into cash at a future date, non-financial reasons such as increasing publicity also play some minor roles (Ritter & Welch, 2002).

Numerous empirical studies have shown that, even though there is a significant degree of variation on its extent, on average IPOs underpricing has been observed all over the world, across time. In their summary of several IPO empirical studies across 25 countries, Loughran, Ritter, and Rydqvist (1994) reported average country-level initial returns ranging from 4.2% (France) to 80.3% (Malaysia). According to Ljungqvist (2007), while the average underpricing in USA IPO markets fluctuates between 10%

and 20% range, it is considerably lower in France and Germany and higher in Asia. Analyzing a sample of 6,249 IPOs, Ritter and Welch (2002) noted an 18.8% average first-day returns between the years 1980 to 2001. They also stated that this rate has been fluctuating across time: increasing from 7.4% in 1980 to 11.2% in the early 1990s, 18.1% in the middle of 1990s, to 65.0% in 1999 and 2000 before falling back to 14.0 % in 2001.

Regarding Asian IPO markets, even though the studies conducted in these markets are not as extensive as in the USA and European IPO markets, the ones undertaken have documented a higher underpricing level than those of more developed economies. By examining the performance of IPOs in the USA, the United Kingdom, and Japanese market, Jenkinson (1990) finds that, while the discount in the United States and the United Kingdom, on average, is around 10% and 7%, respectively, Japanese IPO rose in price by nearly 55% after one week. Moshirian et al. (2010) also find an average IPO initial return of around 202.63% in China, 70.30% in Korea, 61.81% in Malaysia, 21.43% in Hong Kong, 34.04% in Japan, and 33.10% in Singapore. They also noted a higher initial underpricing in the emerging Asian market than in developed Asian markets.

Different nonexclusive theories have been proposed for explaining IPO underpricing. Loosely, this explanation can be classified into four broad categories: information asymmetry, institutional illustrations, behavioral descriptions, and ownership control.

There are three essential parties involved in IPO markets: the issuing firm, the bank underwriting and marketing the deal, and investors (Ljungqvist, 2007; Ritter, 2003). The basic assumption of information asymmetry-based theories of IPOs underpricing is that one of these parties is better informed than the other. Nevertheless, there is a wide range of views on which party has the information advantage over the rest. While the principal-agent model, proposed by Baron and Holmstrom (1980) and later by Baron (1982), stresses that the better-informed party is the underwriter, Rock's (1986) Winner's Curse portrays the existence of some investors who have superior information over all other investors as well as the issuing firm and the underwriter (which are assumed as "invisible intermediary" in this model). On the other hand, the Signaling theory (Allen & Faulhaber, 1989; Grinblatt & Hwang, 1989) posits that issuers of IPOs are more informed than investors and the underwriters. There is also no agreement on whether IPOs underpricing is a sort of compensation for the resulting uncertainty (as argued by Winner's Curse models) or an incentive to avoid it (Book-building theory) or even a signal about the issuing firm quality (Signaling theory).

On the other hand, institutional explanations account IPOs underpricing to institutional factors like lawsuits, taxes, and price stabilization. In this spectrum, while

some argue that underpricing serves as insurance against future litigation (Hensler, 1995; Tinic, 1988), others relate underpricing to price support services provided by underwriters concerning post-IPO price stabilization underpricing (Benveniste, Busaba, & Whilhelm, 2002). Some also explained under-pricing as a consequence of its tax benefits for the issuing firm.

The basic argument of behavioral-based explanations is the presence of 'irrational' investors who either abandoned their information to go with the flow or hold optimistic beliefs about the prospects for the IPO company merely based on their feelings.

Following the decision to go public, separation of ownership and control of the firm would be inevitable. Theories based on ownership and corporate control describe Underpricing as a subsequent separation, an attempt by the owner to maximize their managerial control (Brennan & Franks, 1997) or to minimize the agency costs (Stoughton & Zechner, 1998).

Considering the Asian IPOs, given that it is an emerging market, empirical studies have found that the corporate governance aspect of the firm plays a significant role in IPO pricing. Despite the fact that the direction of the effect is inconclusive, the firm's ownership structure and its board composition proved to be the most effective internal governance mechanisms in determining the level of Underpricing by previous literature. Therefore, the present study aims to empirically examine the influence of this aspect of the firm on IPOs underpricing by focusing on some board characteristics, namely, its size and independence, and the audit committee.

With the relationship between board size and IPO underpricing, two opposing presumptions can be made. On the one hand, a firm may use the size of its board as a signal to indicate its access to critical external ties and resources, which leads to a positive association between underpricing and board size. On the other hand, according to agency theory, a larger board size can be subject to agency costs. Moreover, it can also reduce uncertainties associated with young firms (Yatim, 2011), hence a negative correlation. However, most of the studies reviewed here document a negative association (Certo, Daily, & Dalton, 2001; Darmadi & Gunawan, 2013; Hidayat & Kusumastuti, 2015).

Board independence is the other corporate governance mechanism usually discussed in the literature. It refers to the proportion of independent outside members of the board. Often, board independence is considered a signal to effective control mechanisms and hence increases firm value. In line with this perception, Howton, Howton, and Olson (2001) reported a direct relationship between a percentage of independent outsiders and initial day return. Examining Indonesian IPO firms, Darmadi and Gunawan (2013) also find a positive association between board independence

and IPO underpricing. Contrary to these, Certo et al. (2001) and Afza, Yousaf, and Alam (2013) find that the proportion of outsiders on the board seems to increase, rather than decrease, the level of underpricing.

The audit committee's primary responsibility is monitoring compliance with internal regulations and ensuring the overall effectiveness of firms' internal controls. In the context of IPO, the presence of an audit committee can decrease the uncertainty generated by information asymmetry and hence reduce underpricing. Contrary to this, Dimovski and Kelly (2004) reported a negative association between the two. Besides, Bedard, Coulombe, and Courteau (2008) and Hidayat and Kusumastuti (2015) find insignificant effect. But Bedard et al. (2008) noted that if the audit committee members are independent and have expertise in financial matters, the level of underpricing of the IPO decreases.

Overall, despite the growing body of literature on the issue, the direction of the corporate governance variable's effect in previous studies has been inconclusive. Therefore, using data from the frontier market (Vietnam) in this paper aims to investigate the issue further.

2. Research Methodology

In this study, the quantitative approach and the aim of the research are explanatory. The data used are cross-sectional data. The samples are the top 100 largest listed companies in the Ho Chi Minh stock exchange (VN100). The 100 constituents are selected as of December 31, 2019, and the data used are the quantitative data from the companies' prospectus. Notably, the IPO and listing process in the Vietnam stock market is hugely different from other markets. Usually, when the companies conduct the IPOs to transfer from private to public equity, they will be listed on the stock exchange quickly. It means that the IPO and listing process could be conducted simultaneously, while the Vietnamese companies have to operate separately. The majority of Vietnamese companies are state-owned enterprises. When they conduct equitizations with the IPO process, the listing stage would be performed two or three years later. Therefore, this study will focus on the listing period with the first trading day and listing prospectus in the Vietnam stock market. The data are analyzed regressively regarding the stages of classical assumption testing.

$$IR = (Pt_1 - Pt_0) / Pt_0 \times 100\% \quad (1)$$

Description:

IR : Initial return

Pt_0 : IPO listing price

Pt_1 : closing price on the first trading day of the secondary market.

This model will be analyzed thoroughly with the model from Mnif (2009):

$$\text{Underprice} = \beta_0 + \beta_1 \text{Bnum} + \beta_2 \text{Ineade} + \beta_3 \text{BS} + \beta_4 \text{Age} + \beta_5 \text{Fsize} + \beta_6 \text{Lev} \quad (2)$$

Description:

Underprice: Underpricing level measured by IR model (1).

Bsize: The board size

Ineade: The number of independent boards

BS: Board of supervisors, measured by using dummy variable (1.0) with the value of 1 if the firm has Board of supervisors coming during IPO listing and 0 if vice versa.

Age: The difference between the year of the firm establishment and the year of the IPO

Fsize: Firm size

Lev: The firm's debt ratio

Mnif (2009) shows that the board size has a positive influence on the level of underpricing. According to Darmadi and Gunawan (2012), the board size variable has a significant relationship with underpricing; a large number of boards are expected indirectly to reduce information asymmetry between the firm conducting IPO listing and potential investors.

Moreover, Mak, Tan, Tan, and Tee (2003) document that the corporate governance's influence on the stock price at the time of IPO and listing indicates the board size has a negative correlation to the premium stock price and even premium market price. Widagdo, Rahmawati, Murni, and Ratnaningrum (2021) also find that board members have a significant influence on stock price and earnings management as well as transparent disclosure. The board size could be considered to influence the premium stock price and premium market price negatively. Therefore, the first hypothesis is proposed as follow:

H1: *The board size has a negative influence on underpricing.*

Besides, the independent degree of the board of directors, called board independence or outside directors, could significantly negatively affect the magnitude of underpricing (Anis, 2009). These statements are also in line with Darmadi and Gunawan (2012), who demonstrated that the board independence is negatively correlated to the level of underpricing. Moreover, the role of board independences

could be shown as transparent advisors to support and provide effective strategies to chairmen and management levels in order to achieve good corporate governance (Rustam & Narsa, 2021), then the second hypothesis is as follows:

H2: *The board independence could have a negative influence on underpricing.*

Additionally, the board of supervisors plays a critical component in the corporate governance structure to create a signal investment for investors regarding the company's quality and information in the prospectus (Shakhatreth & Alsmadi, 2021). According to Bedard et al. (2008), the supervisory board's presence significantly influences underpricing level during the company's IPO. Therefore, the third hypothesis is as follows:

H3: *The board of supervisors has a significantly negative influence on underpricing.*

3. Results and Discussion

The samples used in this study are public companies that conducted a listing in the Ho Chi Minh stock exchange (HOSE) with the 100 largest listed companies (VN100) on 31/12/2019. These listed companies accounted for 70%–80% of market capitalization in HOSE, which measures the performance of VN30 and VNMidcap. The Vietnam stock market is only 20 years old and is still ranked as the frontier market by MSCI and FTSE. This stock market still has significant gaps in listing quality regarding market classification, corporate governance, financial ratio, and disclosure. VN100 could be considered as the best index and market's benchmark to be the samples. Because these companies have large market capitalization and comply with corporate governance and listing regulations, gaps would be minimized in comparisons between listed companies.

Based on the figures in Table 1, the average variable value of underpricing (UP) is around 32%; in other words,

the average stock price selected as samples at the time of listing increased by 32% from the closing price on the first day of trading on. The number also shows that the level of underpricing happened in the sample firms is from 4.2% to 55%. It also indicates that the underpricing level is higher than the research conducted by Tran and Duong (2013) in the Vietnam stock market from 2005 to 2012.

The average value of board size (Bsize) is around 5.72 and nearly equal to 6. This research indicates that the average number of board members' sample companies is five people, including independent and dependent BODs. Since Decree 71/2017-NDCP was issued by the Vietnamese Government in 2017, the listed companies tried to increase the level of compliance with various corporate governance rules applicable to public joint-stock companies.

The Indead variable is researched about the independent board of directors (BODs) in a firm measured by the percentage of independent BODs on the number of BODs. The independent board of directors plays a pivotal role to monitor and evaluate the performance of the board of management. However, the average value of the board independence is around 31.2% means, which the average proportion of board independence in a company is 31.2% of the total number of BODs.

The board of supervisors (BS) variable is a dummy variable with the criteria if the company has a board of supervisors in the period of listing that will be given a value of one and zero if the other way around. BS variable has an average value of 65.1% of companies have a board of supervisors, and nearly 35% of firms do not have a board of supervisors in their corporate governance structure during the listing period.

Referring to sample selection, this research chooses 100 companies as sample criteria. After the statistical model test consisting of partial significance test (Test T), simultaneous significance test (Test F), and the model relevance test or the coefficient of determination (R^2), the result of data processing can be viewed in Table 2.

Table 1: The Descriptive Statistics from the Dependent Variable of Underpricing from the Firm Samples in VN100

Variables	Mean	Median	Modus	Max	Min	Std. Deviation
Up	0.3205	0.2129	0.5221	0.5518	0.0428	0.2284
Bsize	5.7287	5.0000	5.0000	10.0000	4.0000	2.8055
Indead	0.3122	1.0000	0.3333	0.6565	0.0000	0.1011
BS	0.6519	0.0000	0.0000	1.0000	0.0000	0.7629
Age	16.6520	14.7820	5.8121	105.0800	0.0000	14.7720
Fsize	3.06E+12	7.20E+11	0.0000	7.07E+13	2.12E+10	1.19E+13
Lev	0.8083	0.8180	0.5059	1.8139	0.0627	0.2412

Table 2: The Result of the Model Regression of the Research

Variables	Coefficient	Std. Error	t-Standard	Prob
Bsize	-0.03737	0.00955	-3.3447	0.0051**
Indead	-0.19991	0.19521	-1.5922	0.1995
BS	0.04233	0.04872	0.9912	0.5186
Age	0.00212	0.00192	0.3129	0.8988
Fsize	5.11E-16	1.91E-15	0.3966	0.8955
Lev	-0.22191	0.07552	-3.1123	0.03118*
C	0.05129	0.08989	6.8212	0
R-squared	0.19012			
Adjusted R-squared	0.12115			
F-statistic	3.01921			
Prob (F-statistic)	0.01211*			

Note: *Shows significance level at 5% and ** 1%.

According to Table 2, the value of R^2 is 0.190, and this means that the underpricing variable can be interpreted by the variations of the independent variable, including the board size, independent board of directors, board of supervisors, firm size, and the leverage of 19%; however, the rest of factors is not included in this study that accounts for 81%.

Furthermore, the value of adjusted R^2 in this study indicates the need for additional independent variables, shown by the smaller value of adjusted R^2 than the value of R^2 . Additionally, the t statistic test is taken to show how significant effects on an individual or partial independent variable on explaining the influence of the dependent variables. Regarding the t -test, the considerable level is 1% and 5%, depending on the probability value at t -stat.

In terms of the regression results, the t -stat value for variable Bsize is around -3.344 with a probability value of 0.0051, which means that the Bsize variable has a negative coefficient on underpricing and gets a significant influence on $\alpha = 1\%$. It can be said that the research's results tend to support the research hypothesis H1, which means that the board size has a negative effect on underpricing, so that the higher number of board of directors, the smaller level of underpricing would be. It means that the board size could decrease the information asymmetry in the investors' minds. The negative correlation between the board size and underpricing shows that with the greater board size, each member in the board will contribute outcomes differently. Additionally, the large size of the board can be more effective in increasing the role of corporate governance structure in the company; it may help decrease the information asymmetry in the stock market and the dictatorship in management. Based on Xie, Davidson, and Dadalt's (2001)

research regarding profit management, the large board size tends to have independent directors more experienced in the financial industry. Hence, a greater board size could be better in reducing the firm's profit management. Mnif (2009) and Hearn (2011) also found that the board size has a significant coefficient of negative influence on the underpricing. Besides that, Xie et al. (2001) also found that board size has a significant negative impact on underpricing. Those studies illustrate that the number of board directors plays a crucial role in decreasing corporate information asymmetry. The board size could measure the ability of coordination and communication. Another research from Mak et al. (2003) also found that the board size, as a part of the corporate governance structure with a negative correlation to the premium stock offering price as well as the premium market price, tending to the greater the board size, the stock price at the time of the listing and IPO to be lower, so the higher the level of underpricing.

Based on the figures in Table 2, the Indead variable shows the t -stat value of -1.59, including a probability value of 0.199. It means that the Indead variable has a negative correlation and no significant effect. Hence, hypothesis H2 could be not supported by this result, meaning that the independent board of directors would not influence the underpricing of a firm doing IPO and listing. It also illustrates that the independence level of the board of directors could not fully control tasks from corporate management. Remarkably, the independent board of directors could not control the firm's ability to decrease fraud in the financial reports and internal cross trading. In this empirical research, it could be showed that the lowest value of the Indead variable explaining the dependent board

of directors is 0, while the maximum value is around 65%. It also illustrates that many firms will be public companies in listing IPOs period without the independent board of directors. Yatim (2011) and Hidayat and Kusumastuti (2015) also found the same results in Malaysian Stock Market and Indonesia Stock Market, where they have some same points in corporate governance structures.

Additionally, the role of an independent board of directors could not be found an underpricing level during the first listing IPO. The old board of directors and founder can be reliable to run businesses than younger ones. Furthermore, the group of founders and owners tend to do not have other guys like an independent board of directors in their companies (Yatim, 2011).

In Table 2, the t -stat value for the BS variable is 0.99 with the probability value of 0.51, meaning that the variable AC has a positive correlation without a significant influence on the $\alpha = 5\%$. The results could not support the hypothesis H3, meaning that the existence of the board of supervisors could not influence underpricing when the firms are doing IPO listing. According to Mnif (2009), the board of supervisors can influence underpricing during the listing period. The board of supervisors cannot be used as a signal, which the listed companies have run their monitoring function well and are also very useful for investor relation directors to persuade investors to buy their stock offering. Therefore, it may be caused by many Vietnamese listed companies that are less aware of the corporate governance structure's importance. The corporate governance's standards have many limitations in the Vietnam stock market, particularly the role of the independent board of directors and board of supervisors.

In this empirical research, the concept of corporate governance could be explained its effect on underpricing. Effective corporate governance is showed capable of explaining and affect underpricing as well as capable of the company model to decrease the information asymmetry and increase transparency for investors.

4. Conclusion

This research's results show that the size of the board of directors directly influences the level of underpricing, while the independent board of directors, known as outside directors, does not have a significant influence on the level of underpricing. Moreover, the board of supervisors also does not play an essential element for a considerable effect on underpricing. As a result, the listed companies may focus on a corporate governance structure to signal investors and particular global investors about the company's performance. The more significant number of directors may influence the lower level of underpricing and help reduce the level of corporate information asymmetry. In this study, the results could contribute to researchers and regulators concerning

the influence of corporate governance structure on the underpricing of stock price. Typically, the effective corporate governance implementation could reduce the information asymmetry and increase transparent disclosure for investors. In particular, it could show potential problems from corporate governance structure to help regulators improve the level of policies. However, this research also has some limitations regarding samples and timeframe. Future studies should use more extended intervals periods and more models to create a comprehensive picture to illustrate the vital role of corporate governance in the Vietnam stock market.

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