Political Ties and Venture Capital: Evidence from China

A thesis presented in fulfilment of the requirement for the degree of Doctor of Philosophy in Finance at Massey University, Palmerston North, New Zealand

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“Eventually everything connects - people, ideas, objects. The quality of the connections is the key to quality per se”

–Charles Eames
ABSTRACT

This thesis investigates whether venture capital firms (VCs) benefit from political ties (PTs), and whether VCs add value to China’s public equity market by constraining earnings management (EM) and improving corporate governance of their backed firms. The first essay examines whether PTs facilitate VCs’ successful exits via either initial public offerings (IPOs) or merger and acquisitions (M&As). Using a sample of 2578 Chinese portfolio firms that received their initial VC funding during 2004-2010, this essay shows that PTs increases the likelihood of VCs’ successful exit through mainland stock markets and M&A markets. It further shows that VCs with management-level PTs enjoy greater success than those with ownership-level PTs, whereas no significant difference between central and local government PTs on VC exits.

The second essay examines whether VCs with PTs are better able to constrain opportunistic earnings management (EM) in Chinese IPO markets. It shows that IPOs backed by VCs with ownership-level PTs are more likely to conduct opportunistic IPO-year EM, while those backed by VCs with management-level PTs are associated with lower IPO-year EM. The higher EM in IPOs backed by VCs with ownership-level PTs is mainly driven by VC lock-up sale within six months following VC lock-up expiration, while the lower EM in IPOs backed by VCs with management-level PTs is not significantly associated with VC lock-up sale. Lastly, IPOs subject to immediate exits from VCs with ownership-level PTs exhibit poorer post-issue stock performance, while
IPOs backed by VCs with management-level PTs exhibit better post-issue stock performance regardless of VC lock-up sale.

The final essay investigates how VCs influence the size and composition of corporate boards. Using hand-collected data from 924 IPO prospectuses, this essay shows that VC-backed IPOs have more independent boards in China. Furthermore, VCs with management-level PTs improve governance by using their networks to recruit specialist independent directors with industry relevant expertise. Lastly, this essay shows that IPOs with more independent boards are not necessarily associated with better performance. However, IPOs backed by VCs with management-level PTs and firms that have a larger percentage of independent directors with industry relevant expertise exhibit higher long-term stock returns.
ACKNOWLEDGEMENTS

First and foremost, I would like to express my greatest gratitude to my supervisors, Associate Professor Jing Chi and Professor Hamish Anderson, for their patient guidance and continuous support in completing my PhD thesis. They were very patient with my rough proposals and drafts and gave me invaluable comments and suggestions for improving the three essays contained in this thesis. Their guidance helped me in all the time of research and writing of this thesis.

I am grateful to Massey University Research Fund (MURF) and Massey University Doctoral Scholarship for financial support. I also want to extend my gratitude to the School of Economics and Finance for creating a delightful learning environment that facilitates me to accomplish this task. Special thanks are dedicated to Dr Chris Malone who wrote in one of my written projects for his Mastery paper- Advanced International Finance- that I could be a very promising PhD candidate. His words encouraged me to pursue the PhD degree when I was not sure about my writing skills, given that English is my second language. My grateful thanks are also extended to Fong Mee Chin for helping me with databases, Cameron Rhodes for IT support, and Sue Edwards and Maryke Bublitz for administrative support.

Many thanks to my PhD mates and friends who have made my PhD journey a memorable one. When I first started my PhD, I received valuable advice from senior PhD fellows Karren Khaw and Suresh Oad Rajput. They have been a great inspiration to me and helped me a lot throughout my PhD journey. We used to have long discussions about our research during after-lunch walk. Even after they graduated, we
discuss our research through internet tools. I also appreciate the support from Mui Kuen Yuen, who has given me a lot of advice on both my personal and academic life.

I would also like to thank the insightful comments provided by Candie Chang, Andrea Bennett, Ben Marshall, Terry Walter, Jason Zein, Mark Humphery-Jenner, Alireza Tourani-Rad, Kai Li, Petko Kalev, David Michayluk, Carole Comerton-Forde, Lorraine Warren, and Jared Stanfield, conference participants at the 2013 online Workshop on Venture Capital and Private Equity in the Asia-Pacific, the School of Economics and Finance Seminar at Massey University, the 2014 and 2015 New Zealand Financial Colloquium, the PhD symposium of the 2014 Financial Management Association International in Tokyo, and the Fourth SIRCA Young Research Workshop in Sydney.

Lastly but not the least, I would like to express my gratitude to my family, the strongest supporters of my life. I thank my fiancé, Qinyuan (Quin) Chen, for his heartfelt love and support through writing this thesis. I also thank my elder sister and brother for always cheering me up during my PhD journey. I am forever indebted to my parents - Yongheng Wang and Yuanjin Zhu - for their endless patience and encouragements. They have cherished with me every great moment and supported me spiritually and financially whenever I needed it. Their love and trust have been the most essential for me. This thesis is dedicated to my parents.
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