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The Impact of Political Connections on Chinese Listed Firms

A thesis presented in fulfilment of the requirements for the degree of

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Abstract

This thesis investigates the impact of a new type of “princeling” political connection on Chinese listed companies. Three specific issues are examined through three interconnected essays: characteristics of “princeling” politically connected firms (PCFs) with respect to accounting numbers in financial statements and corporate governance; the expropriation on earnings by PCFs; and the impact of political connections on stock returns.

Firstly, to examine the characteristics of PCFs, this thesis systematically examines the differences between PCFs and their matching firms with respect to financial statement accounts and corporate governance during the period from 1992 to 2011. This thesis finds that PCFs have significantly greater profitability and market valuation, but they have significantly lower net investments and net fixed assets compared to non-connected firms. Moreover, board directors are on average older and have higher educational levels in PCFs, relative to non-connected firms. Surprisingly, PCFs exhibits larger percentage of directors with academic backgrounds.

Secondly, an investigation is made on the link between political connections and value expropriation. This thesis finds PCFs stockpile disproportionately larger retained earnings but pay lower cash dividends, compared to unconnected firms. This thesis further finds such behaviour in PCFs is not due to either investment or precautionary motives. These results immediately give rise to the question of what happens to the retained earnings. By examining the components of retained earnings, this thesis identifies a new form of tunnelling in the form of a discrepancy in the accounting for changes in retained earnings, newly defined as “grey usage”. Specifically, PCFs have higher average grey usages on retained earnings than matching firms, by CNY 4.68 million. The findings provide important information for investors that PCFs may potentially increase the risk of expropriation through grey usages.

The final examination investigates the market response to the “princelings” political connection. This thesis compares the cumulative abnormal stock returns between PCFs and unconnected firms. Three benchmarks are applied: cumulative market adjusted abnormal returns (CMAARs); cumulative risk adjusted abnormal returns (CRAARs); and cumulative abnormal returns adjusted from the Fama-French three factors model (CFAARs). No matter which benchmark is used, firms connected to PCFs show higher cumulative abnormal stock returns than matching firms. Also, this study finds that PCFs outperform matching firms in the Conglomerates and Industrials sectors, but not in others. This result could be due to the predominance of firms in the Conglomerates and Industrial sectors in the connected firm samples.
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Table of Contents

CHAPTER ONE: INTRODUCTION

1.1 Introduction ................................. 2
1.2 Overarching literature review ................. 3
1.3 Essay One: The difference between politically connected and non-connected firms: A new type of political connection and evidence from the Chinese stock market .............................................. 4
1.4 Essay Two: Expropriation during profit distributions in politically connected firms: Evidence from the Chinese stock market ............................................................. 5
1.5 Essay Three: Market reaction to the “princelings” connection ................................. 6
1.6 Structure of the Thesis .......................... 6

CHAPTER TWO: OVERARCHING LITERATURE REVIEW

2.1 Introduction ........................................ 8
2.2 Expropriation by controlling shareholders ............................................................ 9
2.3 Overview of Chinese stock market ................................. 12
   2.3.1 Dividend policy in Chinese stock market ............................................. 15
      2.3.1.1 Dividend payments process timeline for a Chinese listed firm ............ 15
      2.3.1.1.1 Board vote ................................................................................. 16
      2.3.1.1.2 Declaration date ................................................................. 17
      2.3.1.1.3 Record date, Ex-dividend date, and payable date .......................... 18
      2.3.1.2 Agency theory of dividend policy ............................................. 19
      2.3.1.3 Dividend puzzle in China ......................................................... 21
         2.3.1.3.1 Two types of dividend payments ........................................ 21
         2.3.1.3.2 Salient features of dividend policy in China ............................ 22
         2.3.1.3.3 Empirical evidence on dividend policy in China ...................... 26
         2.3.1.3.4 The long road to regulatory reform on cash dividend distributions........ 28
      2.3.2 Political influence on the stock market ........................................... 31
         2.3.2.1 Helping hand ................................................................. 32
         2.3.2.2 Grabbing hand ................................................................. 33
   2.4 Corporate governance ........................................... 34
      2.4.1 Internal governance ................................................. 35
         2.4.1.1 Ownership structure ......................................................... 35
            2.4.1.1.1 SOEs reform ................................................................. 35
            2.4.1.1.2 Non-tradable share reform .............................................. 37
            2.4.1.1.3 Ownership concentration ............................................... 39
      2.4.1.2 Board Characteristics ...................................................... 40
         2.4.1.2.1 Board of directors ......................................................... 41
         2.4.1.2.2 Independent board of directors and specialized committees ....... 42
List of Tables

Table 3:1: The sample ......................................................................................................... 75  
Table 3:2: Univariate tests ................................................................................................ 90  
Table 3:3: Correlation matrix .......................................................................................... 95  
Table 3:4: Political connections and accounting based numbers .................................... 97  
Table 3:5: OLS regressions explaining Hypothesis 1a to 1c ............................................ 102  
Table 3:6: Political connections among different industries ......................................... 104  
Table 3:7: Political connections in the sub-period during 1992-2004 and 2005-2011 .... 107  
Table 4:1: Descriptive statistics ...................................................................................... 138  
Table 4:2: Political connections, operating performance and growth opportunities .... 145  
Table 4:3: Political connections and operating tunnelling .............................................. 147  
Table 4:4: Political connections and profits sharing distribution ................................... 150  
Table 4:5: Summary statistics on grey usages ................................................................. 153  
Table 4:6: The relation between the grey usage and stock return ................................... 158  
Table 4:7: Potential mechanism to divert the grey usage ............................................... 160  
Table 4:8: Potential mechanisms in place to divert grey usage in the sub-period 1998-2005 ........................................................ ........................................... 162  
Table 4:9: Potential mechanisms in place to divert grey usage in the sub-period 2006-2011 .................................................................................................................. 163  
Table 5:1: Cumulative abnormal returns (CARs) statistic for full samples .................... 192  
Table 5:2: Determinants of cumulative abnormal stock returns (CARs) for full sample 195  
Table 5:3: Determinants of CARs across different sub-periods .................................... 197  
Table 5:4: Determinants of CARs of firms across five industries ................................. 200  
Table 6:1: Hypotheses and conclusions for three key research aims ............................. 215
List of figures

Figure 2.1: Top 10 of market capitalization of listed domestic firms in the world by 2011 ................................................................. 13

Figure 2.2: The dividend payment process time line for a publicly listed company .......... 15

Figure 2.3: Total financing and cash dividend of A-share companies during 1992-2011 .. 24

Figure 2.4: Public enforcement taken by the CSRC from 2001-2015 ......................... 54

Figure 2.5: Private Enforcement taken in the Supreme People’s court during 2001-2011. 56

Figure 4.1: The relationship between Block and grey usages for PCFs and unconnected firms, respectively ................................................. 176
List of Charts

Chart 3.1: PCFs compared to unconnected firms on accounting based information........ 110
Chart 4.1: The differences between politically connected firms (PCFs) and unconnected
firms in variables used to test hypothesis 1. ................................................................. 166
Chart 4.2: The differences between PCFs and unconnected firms in variables used to test
hypothesis 2 ...................................................................................................................... 168
Chart 4.3: The differences between PCFs and unconnected firms in variables used to test
hypothesis 3 ...................................................................................................................... 170
Chart 5.1: Cumulative stock abnormal returns adjusted from market index returns
(CMAARs)....................................................................................................................... 204
Chart 5.2: Cumulative abnormal stock returns from market model (CRAARs) ............ 205
Chart 5.3: Cumulative abnormal stock returns from Fama-French three Factors (CFAARs)
........................................................................................................................................... 206
Chart 5.4: CMAARs across five different industries...................................................... 208
Chart 5.5: CRAARs across five different industries....................................................... 209
Chart 5.6: CFAARs across five different industries....................................................... 210