

Copyright is owned by the Author of the thesis. Permission is given for a copy to be downloaded by an individual for the purpose of research and private study only. The thesis may not be reproduced elsewhere without the permission of the Author.

The Impact of Political Connections on Chinese Listed Firms

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

Doctor of Philosophy

in

Finance

at Massey University

Palmerston North, New Zealand

XiaoQi Chen

2016

Copyright is owned by the Author of the thesis. Permission is given for a copy to be downloaded by an individual for the purpose of research and private study only. The thesis may not be reproduced elsewhere without the permission of the Author

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.

Acknowledgment

The completion of my dissertation and subsequent Ph.D has been a long journey. It is true that “Life is what happens” when you are completing your dissertation. Life doesn’t stand still, nor wait until you are finished and have time to manage it. Much as happened and changed in the time I’ve been involved with this project. Many have questioned whether I would finish my dissertation, and have doubted my commitment to it. I, on the other hand, barring losing confidence so many times I’ve lost count, getting writer’s block just as any times, computer crashing, and pure frustration in general, knew I’d complete my Ph.D.

I could not have succeeded without the invaluable support of several. Without these supporters, especially the select few I’m about to mention, I may not have gotten to where I am today, at least no sanely. To this select group, I would like to express my special appreciation and thanks, beginning with my main supervisor Dr. JG. Chen. His patience, flexibility, genuine caring and concern, and faith in me during the dissertation process enable me to attend to life while also earning my Ph.D, He’s been motivating, encouraging, and enlightening. He has never judged nor pushed when he knew I needed to juggle priorities. When others doubted, he remained a fan. He has been a tremendous mentor for me. I would like to thank him for encouraging my research and for allowing me to grow as researcher. I cannot thank him enough. I am forever grateful. Thank You, Dr. JG.

I would also like to give a heartfelt, special thanks to Dr. Jing, Chi and Dr. Carolyn, Wirth. Their flexibility in scheduling, gentle encouragement and relaxed demeanour made for a good working relationship and the impetus for me to finish. I am thankful to them for believing that I am able to complete my doctoral degree, which is not merely an academic qualification, but also a journey of discovery that needs much patience, persistence and perseverance.

Thirdly, I am very grateful to the Head of School of Economics & Finance, Professor Martin Young, and Associate Professor David, Tripe. I thank all of you for helping me through all the difficulties. Many thanks also go out to the faculty members at Massey University, Fong Mee Chin for her help with the data, Cameron Rhodes for his technical assistance, and Maryke Bublitz for her administrative support.

Many thanks to my PhD mates and friends who have made my study here a memorable one! Their kindness and friendship will always be remembered. Finally, a special thanks to my family. Words cannot express how grateful I am to my grandfather and grandmother for all of the sacrifices that you’ve made on my behalf. This PhD thesis is dedicated to the memory of my grandmother Linying Guo. I would also like to thank my beloved husband and parents in-law. Thank you for supporting me in everything and especially I can’t thank you enough for looking after my beloved daughter while I studied in New Zealand alone.

Table of Contents

CHAPTER ONE: INTRODUCTION	1
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	7
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

2.4.1.2.3 Supervisory board	44
2.4.1.2.4 Shareholders' right and Shareholders' meeting	45
2.4.2 External governance	46
2.4.2.1 Information disclosure and transparency	46
2.4.2.1.1 Rules and regulations	46
2.4.2.1.2 Financial reporting practice.....	48
2.4.2.1.3 External Auditors	49
2.4.2.1.4 Stock price synchronicity movement	51
2.4.2.2 Legal framework	51
2.4.2.2.1 Public enforcement institutions.....	52
2.4.2.2.2 Private enforcement.....	54
2.4.2.3 Bank monitoring	56
2.4.3 Conclusion on corporate governance	58
2.5 Conclusions	59
CHAPTER THREE: ESSAY ONE: THE DIFFERENCE BETWEEN POLITICALLY CONNECTED AND NON-CONNECTED FIRMS: A NEW TYPE AND EVIDENCE FROM THE CHINESE STOCK MARKET	61
3.1 Introduction	62
3.2 Literature review	65
3.2.1 Potential benefits of political connections: "Helping" hands theory.....	65
3.2.2 Potential costs of political connections: "Grabbing" hands theory	66
3.2.3 Political connection research in Chinese firms.....	68
3.3 Data.....	69
3.3.1 Definition.....	69
3.3.2 Sample selection	70
3.3.2.1 Political connection to princelings' families.....	70
3.3.2.2 Political connection to other high-ranking public officials.....	72
3.3.3 Sample description	73
3.3.3.1 Descriptive statistics	73
3.3.3.2 Matching procedure	76
3.4 Hypotheses and methodology.....	77
3.4.1 Hypotheses development	77
3.4.2 Methodology and models	83
3.5 Empirical analysis	86
3.5.1 Univariate tests	86
3.5.2 Pair-wise correlation test	94
3.5.3 Regressions	96
3.5.3.1 Logistic regression results.....	96
3.5.3.2 OLS regression results	101
3.6 Robustness tests	103

3.6.1 Tests on different industries	103
3.6.2 Tests on sub-period.....	105
3.6.3 Time patterns	108
3.6.4 Discussion on the “princelings” connection and causality	113
3.7 Conclusions	113
CHAPTER FOUR: ESSAY TWO: EXPROPRIATION DURING PROFIT DISTRIBUTIONS IN POLITICALLY CONNECTED FIRMS: EVIDENCE FROM CHINA	115
4.1 Introduction	116
4.2 Literature review	120
4.3 Model and hypothesis development.....	123
4.3.1 Model 1: Operating stage tunnelling	124
4.3.2 Model 2: Distribution stage wealth expropriation	127
4.4 Data and methodology	136
4.4.1 Data source	136
4.4.2 Methodology.....	137
4.5 Empirical results	137
4.5.1 Univariate results	138
4.5.2 Regression results	143
4.5.2.1 <i>Hypothesis 1: political connections, operating performance and growth opportunities.</i>	143
4.5.2.2 <i>Hypothesis 2: political connections and tunnelling at the operating stage.</i>	146
4.5.2.3 <i>Hypothesis 3: political connections and profits allocations</i>	149
4.5.2.3.1 Hypothesis 3a: Political connections and dividend-retained earnings	149
4.5.2.3.2 Hypothesis 3b: Political connections and the “Grey” usage of earnings	152
4.5.2.3.2.1 Grey usage and stock returns	157
4.5.2.3.2.2 Potential mechanisms in place to divert the grey usage	159
4.6 Robustness tests	164
4.6.1 Time trends	164
4.6.1.1 <i>Hypothesis 1</i>	166
4.6.1.2 <i>Hypothesis 2</i>	168
4.6.1.3 Hypothesis 3.....	170
4.6.1.3.1 Hypothesis 3a	170
4.6.1.3.2 Hypothesis 3b.....	172
4.6.2 Other tests	174
4.7 Conclusion.....	177

CHAPTER FIVE: ESSAY THREE: MARKET REACTION TO THE “PRINCELINGS” CONNECTION	180
5.1 Introduction	181
5.2 Literature review	183
5.3 Data and Methodology	185
5.3.1 Data.....	185
5.3.2 Hypothesis development.....	186
5.3.3 Methodology.....	187
5.3.3.1 Cumulative market adjusted abnormal returns (CMAARs)	188
5.3.3.2 Cumulative risk adjusted abnormal returns (CRAARs)	188
5.3.3.3 Fama-French three factors model	189
5.4 Empirical Results	190
5.4.1 Univariate tests	190
5.4.2 Regressions	193
5.4.2.1 Test on full sample.....	193
5.4.2.2 Test on sub-periods	196
5.4.2.3 Test on five different industries	199
5.5 Time Patterns.....	203
5.5.1 Different sub time periods	203
5.5.2 Test on five different industries.....	207
5.6 Conclusions	211
CHAPTER SIX: CONCLUSIONS.....	212
6.1 Review of theoretical contributions	213
6.1.1 New type of political connection: “Princelings”	213
6.1.2 New theory of “Golden hens vs. Chickens”	213
6.1.3 New theory of “Grey” usage	213
6.2 Review of hypotheses, major findings and implications.....	214
6.2.1 Essay One: The difference between politically connected and non-connected firms: A new type of political connection and evidence from the Chinese stock market	216
6.2.2 Essay Two: Expropriation during profit distributions in politically connected firms: Evidence from the Chinese stock market.....	216
6.2.3 Essay Three: Market reaction to the “princelings” connection	217
6.2.4 Limitations of the thesis and future areas of research	218
APPENDIX A	220
BIBLIOGRAPHY	221

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