The Impact of Political Connections on Chinese Listed Firms

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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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