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UNIVERSIDADE CATÓLICA PORTUGUESA

Master of Science and Economics

High-level corporate political connections and firm's value – evidence from Portugal

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Dissertation submitted in partial fulfillment of requirements for the degree of MSc in
Economics, at the Universidade Católica Portuguesa.

Lisbon, June 2012

Acknowledgements

This Master thesis is the result of a long process of hard work which without the support of some special people would not have been possible. Thus, I want to express my gratitude to them all.

In first place, I want to thank to professor Ricardo Reis for introducing me to the topic of political connections and the business environment, for his thoughtful guidance during all the thesis process, and for his enthusiasm and encouragement especially in moments of desperation. I want to tank to professor Geraldo Cerqueira who patiently gave me an incredible support and helped me in various domains of this thesis. I also want to thank to professor Joaquim Miranda Sarmiento for his critical and sincere opinion.

I am also grateful to all my family, for supporting me in my decisions and believing in me since the first day of my life. To my great-aunt I thank the unbending Faith in me and for her presence in my life. To my mother I thank the fact that I become a demanding person with myself. To my father I thank the adventurous spirit, the courage to walk further and to provide me the tools to make these possible.

I wish to tank to my beloved group of friends. I am grateful to Francisco for all the support during these 5 years of university, for the fact that he lovingly supported my bad temper, and especially for being a friend for life. I also want to thank to Filipa, Maria and Patrícia for the tears they helped to clean, for their unconditional support in all moments, and for being like sisters to me.

I would like to dedicate this thesis to my grandmother, who left during my thesis process.

Abstract

The aim of this study is to test whether in the Portuguese framework the appointment of former politicians to a top management or board firm position is linked to a change in firm's value. If firm's performance is affected, it will be capitalized into equity prices, and we may expect it to be due to the investor's anticipation of future political benefits, such as: easier access to debt financing; lower taxes; power to influence the laws under which the firm operates; possibility of winning government contracts, and stronger market power. This Business-Government interface has never been studied in the context of the Portuguese economy. Thus, to address this issue, this study uses an original hand-collected data set based on 46 firms that exchange in the Euronext Lisbon, and based on the composition of the Portuguese Constitutional Governments from January, 1980 to April, 2012. The results suggest that, in average, the appointment of a politically connected executive leads to a negative impact on firm's value which is noticeable by the significant and negative abnormal stock returns. The results further suggest that, regardless of the political party to which an executive is linked, his appointment is also recognized by investors as a damaging strategy for the business. The only exceptions are the appointments where the number of former politicians linked to each party is balanced. Moreover, the results reveal that investors tend to alleviate the negative impact of a political appointment when they know which position those executives will occupy as well as the level in the corporate governance hierarchy to which each position corresponds. However, we should stress that these conclusions are limited by the small sample of political appointments – only 23% of our appointments are related with the nomination of politically connected executives. Moreover, our lack of capacity to control for potential leakage of information prior to the day of the appointment can be undermining more accurate results.

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1. Introduction

Why do have firms interest in having access to political power? Several studies (Baysinger, Keim, and Zeithaml, 1985; Hillman, Zardkoohi, and Bierman, 1999; Chen, Ding, and Kim, 2010) on business research suggest that there is a diversity of benefits that may flow to firms that can successfully establish a linkage with the Government. Firms have interest in having access to political power, because governmental entities influence the opportunity sets faced by firms, shaping their competitive environment. Faccio (2006) suggests that politically connected firms may have preferential treatment in competition for Government contracts. Moreover, governmental entities are responsible for the three broad areas of regulation - antitrust regulation, economic regulation, and social regulation- which are crucial for any area of business today. Moreover, Government expenditures represent a huge portion of business for a variety of firms (Hillman, Zardkoohi, and Bierman, 1999). The attention that management researchers have been given to this Government-business interface suggests, at least, the popular perception that benefits of the Government service may spillover to private sector, adding value to the firms. In fact, nowadays is hard to find any area of business that is not somehow affected by the Government.

Despite its popularity, corporate political connections is a relatively new research area in the economic literature, and this study will explore evidence about the relationship that can be established, in the Portuguese case, between high-level corporate political connections and changes in firm's value as a result of a linkage with the political power. Our interest is to explore if political connections are also important to add value when the framework is an economy which has a well developed financial market as well as robust legal system. Given this, our challenge is to investigate whether, in the Portuguese scenario, the appointment of former politicians that begin serving in a top management or board firm position is linked to a change in firm's value. According with the general results provided by the literature on this field of research (Goldman, Rocholl, and So, 2006), to address this question we will assert the hypothesis that when individuals with political experience or political ties are appointed to industry, that is, when a link is established between a firm and the Government through this type of personal service, firm performance will be positively affected, due to the

anticipation of future political benefits. If political connections matter, then the nomination of politically connected board members is capitalized into equity prices and a company's value goes up. These nominations are not mere preferences of the industry. However, one may think that strong political ties can also decrease firm value due to the risk that politically connected board members may divert firm resources in order to serve other political goals. Actually, Shleifer and Vishny (1994) emphasizes that politically connected executives may extract at least some of the rents generated by connections, and firm's value will be enhanced only when the marginal benefits of the connections outweigh their marginal costs.

In order to address our goal, we use the event study methodology. This approach allows us to confidently determine whether there is an abnormal stock price effect related with a specific unanticipated event. We also assume our own definition of political connections which is based on detailed data on the former political positions held by each board member appointed by each firm that exchange on the Euronext Lisbon. Since there are other drivers for a firm to get connected, the level of political connections which we pretend to perform in this study will be a lower bound on the actual degree of political lobby. To get our sample of appointments we look to all the announcements made by each firm to the Comissão do Mercado de Valores Mobiliários (CMVM) between the periods of January, 2000 to April, 2012.

It is important to highlight the lack of previous empirical research in this specific type of corporate political behavior, which proved to be one of our major difficulties for this analysis to be done. Another limitation regarding this study was the dimension of our sample, which is relatively small. We measured the firm's performance as the daily stock quotes, thus our sample becomes restricted to the firms that exchange in the Euronext Lisbon. Notwithstanding, our sample experienced a further constraint, since the politically connected firms represent the minority of these firms. However, this sampling issue should not distract us from our main findings which consistently suggest that, on average, political connections jeopardize firm's performance.

The rest of this study is organized as follows. Section 2 reviews the existing literature. Section 3 describes the data we use to perform this study. Section 4 presents in detail

the variables we compute. Section 5 describes the methodology. Section 6 presents the empirical analysis and the main results of this study. Section 7 concludes.

2. Literature Review

Research on corporate political activity has gained increasing recognition since the publication of several important studies on the matter (Fleming, 1980; Thai, 1980; Grefe, 1981; Sethi, 1981; Baysinger, and Keim, 1982; Faccio, and Masulis, 2005; Faccio, and Parsley, 2006; Leuz, and Oberhelzer-Gee, 2006; Faccio, 2006, 2009; Fisman, 2001). These studies reveal similar conclusions regarding the evidence that political forces constrain the strategic decisions of multinational firms. Firms that are able to create a linkage with the Government may benefit from a reduction in uncertainty, reduced transaction costs, privileged information, access, influence and legitimacy (Galaskiewicz, and Wasserman, 1989; Hillman, Zardkoohi, and Bierman, 1999; Chen, Ding, and Kim, 2010). For instance, Faccio, Masulis, and McConnell (2006), and Claessens, Feijen, and Laeven (2008) suggest that political connected firms are less dependent from the public in what concerns the need to raise capital, because they can get access to privileged loans from banks that are under political influence. Hillman, Zardkoohi, and Bierman (1999) also suggest that high-level politically connected firms are able not only to influence the regulatory process in a way more favorable to the firm, but also have increased access to Government contracts. Fisman (2001), and Faccio, and Parsley (2006) demonstrate in their studies that when Government officials lose their political influence, firm value with which they were connected diminishes.

Moreover, Crispin (2002) show that political connections significantly affect firm's performance not only in emerging markets, but also in developed economies.

However, while in theory Government relations and strategies may create value for firms, empirically it is difficult to link these activities to measurable performance at the firm level. Political connections are a nonmarket behavior, thus the nature of the direct benefits of the Government service is not easily measured (Hillman, Zardkoohi, and Bierman, 1999; Shaffer, Quasney, and Grimm, 2000).

Scholars that study corporate political activity (Zeithman et al., in press; Baysinger, Keim, and Zeithman, 1985) indicate that the traditional political strategies of direct lobbying and corporate campaign contributions have been complemented or replaced in many firms by more sophisticated approaches. These more recent strategies include campaign contributions through political actions committees (PAC), advocacy advertising, corporate constituency programs, and inter-organizational linkages. Hillman, Zardkoohi, and Bierman (1999) stressed the role of personal service as a means of inter-organizational linkage, and by assuming a critical distinction— instead of two organizations where a decision-maker from one firm becomes a decision-maker in another, we will consider the scenario where one of the organizations is the Government- they showed that the benefits that generally result from inter-organizational linkages and interlocking directorates between two firms also result from a linkage between a firm and the Government through personal service. However, these authors only studied the effect on firm performance of a type of personal service— when a member of a firm’s top management team or board of directors begins serving in a nominated or elected political position. In this way, they provided suspicion that the reverse direction- when those individuals with political background or ties go to industry- may also create firm-specific benefits which can be captured in advance by the markets, leading to changes in firm’s value. Investors view turnover appointments as good news presaging improved management and higher cash flows.

3. Data description

We now look the data we use to analyze the impact of the announcements of former politicians that begin serving in a top management or board firm positions on firm’s value.

3.1. Announcements data

As we said before, we will focus our analysis on firms that trade in Euronext Lisbon, so we start with a sample of 47 firms.

To compute the announcements data, we went to the Comissão do Mercado de Valores Imobiliários (CMVM) official website¹ and we rely on their information available to the public. Then, to each security issuers we took the information related with the day and hour of each appointment, the executives nominated in each appointment as well as their corporate functions. This data was collected in the time period between January, 2000 and April, 2012. We were then forced to exclude one of our initial 47 firms, because there was no information available for Portucel Soporcel Group on these topics. Our final sample of announcements is then composed by 46 firms, 402 announcements and 2536 executives appointed.

3.2 Political data

We can have two types of announcements: political announcements and non political announcements. We assume that an announcement is political when within the set of executives appointed there is at least one executive that at any time before the day of the nomination held a position such as Prime Minister, Minister or Secretary of State during one of the Portuguese Constitutional Governments. This condition leaves out the case of board members who have not political ties at the time of the nomination.

Following this idea, we say that a firm has political connections when, at least one of the executives nominated by the firm, during the period of January, 2001 to April 2012, is politically connected.

In order to address this challenge, that is, identify who among all the executives nominated, has political connections, we went to the Portuguese Government website² and we collected all the data related to the composition of each Constitutional Government from January, 1980 to April, 2012. We get a hand database composed by 14 Governments.

After that, we match the announcements data with this political data so that we are able to identify which executives have political connections and which appointments can be considered political. At this point, we have considered the appointments of three particular executives as an exception to that criterion, because their political ties

¹ <http://web3.cmvm.pt/sdi2004/emitentes/titulares.cfm>

² <http://www.portugal.gov.pt/pt/o-governo/arquivo-historico/governos-constitucionais.aspx>

are prior to the year of 1980. Their strong political connections combined with the frequency with which they are appointed for several corporate positions, in different firms, lead us to not neglect them.³

Table 1: Sample composition

Nº Firms	Nº Appointments (N)	Nº Political appointments	Nº Politically connected firms
46	402	93 (23%)	30 (65%)

Source: Author's calculations based on political data.

Table 1 shows that within our final sample, 65% of our firms have some political connections and 23% of our appointments are political.

An interesting point we can highlight is that, among our 93 political appointments, none of them is due to the appointment of a woman with political past. Actually, only male executives reveal to have political ties.

4. Variables

It may be argued that the announcement effect on firm's value is not only due to the unique political characteristics of the executives appointed. Following this idea, we decide to stress two possible reasons according to which an appointment can have impact on firm's value. We consider that an announcement can have both a corporate and political components, and we have several ways to perform it. In what follows we will give a detailed description of the variables we compute to capture that different effects.

4.1. Corporate variables

The Corporate Governance of a firm is relatively complex and we can find several positions with different functions. For example, we can believe that the chairman of the Board of Directors has a different contribution to the firm than the Corporate Secretary has. On the one hand, Huson, Malatesta, and Parrino (2004) find that

³ We refer to the cases of Artur Eduardo Brochado Santos Silva, Daniel Proença de Carvalho, and José Manuel Ribeiro Sérvulo Correia.

decisions made by principal officers can create or destroy wealth on a large scale, because they play a key economic role. On the other hand, Denis and Denis (1995) report insignificant abnormal returns around the announcement of turnovers that do not involve the top executive and find no significant change in operating performance following such appointments. In this way, we decide to rank those different positions according with the position they occupy in the hierarchy of the corporate governance structure, giving to each of them a score in a range between 0 and 10.

We find two different ways of doing it. The first one is more objective and is based on the fixed salaries declared by each firm on their most recent Annual Report and Accounts. According with this approach we give 10 points to the corporate position with the highest salary and the other board positions will receive a score based on their relative salary to the highest one. However, we face some difficulties when proceeding this way: there is a huge lack of information regarding the fixed salaries of each corporate position; there is no consistency of corporate positions neither within the same firm along the time, nor between different firms. Since the first approach failed we turn to an alternative method. Although being a subjective procedure, it is based on each corporate position functions. Appendix 1 shows in detail the corporate points we attributed to each board position.

For each appointment we compute three corporate variables: the average corporate position, the maximum corporate position and the sum of corporate positions.

The *average corporate position* variable is the simple average of the total points of the announcement_i:

Formula 1:

$$\text{average corporate position}_i = \frac{\text{total corporate points}_i}{\text{total number of executives}_i}$$

where $i = [1,2,3, \dots, 402]$

The *maximum corporate position* variable is the maximum score of each appointment.

The *sum of corporate position* variable is simply the sum of scores of each position that comprises each appointment:

Formula 2

$$\text{sum of corporate position}_i = \sum_{j=1}^J \text{corporate point of executive}_j$$

with $i = [1,2,3, \dots, 402]$ and $j =$ number of nominated executives by appointment⁴.

Table 3: Corporate variables – Descriptive statistics

N ⁵ =405	Average corporate position	Maximum corporate position	Sum of corporate position	Executives by appointment
Average	5	6	31	6
Quartile 25	3	3	4	1
Quartile 50 (Median)	5	6	9	2
Quartile 75	6	10	38	9
Minimum	1	1	1	1
Maximum	10	10	276	47
Standard deviation	2	3	42	8

Source: Author's calculations based on corporate data.

Table 3 reports some basic statistic measures of our corporate variables. As we can observe, the average score of each appointment amounts to 5. However, when we consider the average maximum score this value increases to 6, and when we consider the sum criterion, the average markedly increases to 31 points. The maximum score we can get is the value 10, and it corresponds to the case where the chairman of the Board of Directors is appointed. The minimum score an appointment can get is 1.

⁴ Despite the number of executives nominated by appointment show large variation, in average, each appointment comprises 6 executives' nominations.

⁵ N is the number of appointments that compose our sample.

Among the three criteria, the sum of the corporate points is the one that stresses the most the corporate importance of the appointment.

In what concerns the number of executives nominated by appointment, there is not a typical behavior. In average, an appointment is composed by 6 board members. However, we can get situations of 47 executives being nominated. This diversity is reinforced by the fact that only 25% of the appointments are composed by more than 9 members.

4.2. Political variables

As we mentioned above, we say that an executive has political connections when he, at some point in time prior to the day of the announcement, held a political position such as Prime Minister, Minister or Secretary of State. Following that political hierarchy, we can give a weight to each nominated executive according with his political past. Table 4 of Appendix 2 shows the valuation we made.

Following that procedure, and taking into account the number of times each political connected executive held a certain political position, we can compute for each appointment a variable that is a composite political weight.

Table 5 – Political variables – Political weight

N ⁶ =93	Average political position	Maximum political position	Sum of political position
Average	0.7	4	6
Quartile 25	0.2	1	2
Quartile 50 (Median)	0.3	2	3
Quartile 75	1	4	9
Minimum	0.03	1	1
Maximum	10	14	31
Standard deviation	1.2	4	7

Source: Author's calculations based on political variables.

⁶ N is the number of political appointments.

Table 5 reports some important information about the political appointments. The low values for the average political position means that, in average, each set of executives appointed is composed by few political connected board members. The outlier 10 relates to an appointment where only one executive is announced. Actually, this is the appointment of Jorge Paulo Sacadura Almeida Coelho, which was Minister for five times, for the Board of Directors of Martifer, on the 19th of February, 2009. The maximum political value of an appointment is 14, and it corresponds to the appointment of Álvaro de Pinho Bissaia Barreto, which was Minister for seven times, to the Board of Directors of Banco Comercial Português (BCP), on the 6th of February, 2012.

An alternative approach⁷ to that composite weight is to create a dummy variable that takes the value 1, if the appointment is political, and takes the value 0 otherwise. We label this dummy with the name *Political Appointment*. This second criterion does not consider that different political classes may lead to different effects on the change in firm's value. Actually, it only considers that there may be a different effect depending on whether an executive has a political past or not.

A third way to look at the political board connections is to sort our sample in accordance with the political party that is largely represented in each appointment. To do that, we create four dummy variables. The first dummy variable created, *Socialist Majority*, takes the value 1 if the majority of the political connected executives nominated in the appointment,⁸ have filiations with Socialist Party. It takes the value 0 otherwise. The second dummy we compute, *Democratic Majority*, takes the value 1 if the number of politically connected executives having filiations with the Social Democratic Party or with the Party of the Democratic and Social Center/ Popular Party (CDS/ PP) is the majority. The third dummy computed, *Balanced Appointment*, takes the value 1 when the number of political connected executives having political filiations with Socialist Party or other party from the left is exactly equal to the number of political connected executives that have filiations with Social Democratic Party or other party from the right. It takes the value 0 otherwise. Finally, the fourth dummy

⁷ This alternative approach is the one we use in the empirical section of this study.

⁸ Where $i = [1, 2, \dots, 402]$

we create, *Ruling Party*, captures the linkage between the party that is majorly represented in the appointment and the ruling party. In this way, Ruling Party takes the value 1 if the majorly represented party in the appointment is the same that was ruling at the time of the appointment. When these four dummy variables are equal to 0, then the appointment is composed only by executives without political ties.

Table 6 – Political dummy variables

N=402	Socialist Majority	Democratic Majority	Balanced Appointment	Ruling Party
Number of dummies (=1)	28	52	13	73

Source: Author's calculations based on political variables.

Table 6 shows that among our 402 appointments: 73 are appointments such that the party majorly represented by the politically connected executives appointed is the same than the ruling party at that time; 28 are appointments such that the majority of the politically connected executives nominated are affiliated to the Socialist Party; 52 are appointments where dominates the affiliations to the Social Democratic Party or with the CDS/ PP, and 13 are appointments where the number of politically connected executives from both party is in equilibrium. The remaining 309 are non political appointments.

5. Event study methodology

As we said before, the purpose of this study is to test the effect of a board nomination of a former politician on the change of firm's value. A correct way to assess the financial impact of changes in corporate policy, whether endogenous or exogenous, is to use the event study methodology. This approach allows us to confidently determine whether there is an abnormal stock price effect related with a specific unanticipated event⁹.

⁹ We assume that the moment when a firm appoints an executive to a corporate position is only known by the market and investors when it is published by the CMVM. We are assuming that there are not situations of leakage of information.

We will follow Mc Williams and Siegel (1997), and use the traditional approach to obtain estimates of abnormal returns. We run market model regressions of the realized daily stock returns¹⁰ for event portfolio i ¹¹, $r_{i,t}$, on a measure of the realized daily returns of the market index¹², r_{mt} , and a set of $2\tau + 1$ daily event dummies, δ_{ikt} , $k = -\tau, -\tau + 1, \dots, 0, \dots, \tau - 1, \tau$, which take the value of 1 for days inside the event window¹³ ($t = k$) and 0 outside the window.

Formula 3

$$r_{it} = \alpha_i + \beta_i r_{mt} + \sum_{k=-\tau}^{\tau} \gamma_{ik} \delta_{ikt} + \varepsilon_{it}$$

The coefficients γ_{ik} measure the daily abnormal returns inside the event window. These abnormal returns are assumed to capture the stocks market's reaction to the arrival of new information.

In what follows, we assume always three different event windows. The first one considers the 10 days prior to the event, as well as the 10 days after the event. The second window analyzes the 3 days prior and after the event, and the last window comprises the day before and the day after of the appointment. Our estimation window comprises the 250 days prior to the day of the event. The nontrading of certain stocks is a recurrent situation on the Euronext Lisbon. Thus, in order to prevent nonsynchronous trading between the security's daily prices and the PSI 20, which functions as the Portuguese financial benchmark, we correct each security's daily returns series by adding the value 0 when there is no trading.

Sums of the daily abnormal return estimates, $\hat{\gamma}_{ik}$, over various windows yield cumulative abnormal returns (CAR) estimates.

¹⁰ We use the daily returns gross of dividends instead of the normal daily returns because they have less noise. Thus, they allow us to better control for confounding effects. These returns are available at Bloomberg data base.

¹¹ $i \in [1, 2, \dots, 402]$.

¹² For this purpose we use the PSI20 Index. We obtain this series from Bloomberg data base.

¹³ As we said before, we define an event to be the date of an appointment of a board member or set of board members.

We get three different CARs series, one for each event window. Since we are dealing with daily data, we decide to use the normalized¹⁴ CARs instead of the traditional CARs, because in this way we can get even more accurate results.

Table 7: CARs (%) – Descriptive statistics

	CARs (-10, +10)	CARs (-3, +3)	CARs (-1,+1)
N	401 ¹⁵	402	402
Mean	0.000	-0.188	-0.545
Quartile 25	-1.79	-3.515	-4.256
Quartile 50	-0.135	-0.171	-0.596
Quartile 75	1.612	2.753	3.616

Source: Author's calculations based on CARs series.

Table 7 reports some descriptive statistics for the normalized CARs series we get. As we can observe, only the CARs series for the event window (-10, +10) has a clear null mean. These results suggest that, in average, the cumulative abnormal returns around the event are negative.

In order to test the statistical significance of the cumulative abnormal returns, we have to assume the standard assumption that the values of CAR_i are independent and identically distributed. In this way, we can compute the average cumulative abnormal returns (ACAR) as follows:

Formula 4

$$ACAR_t = \frac{\sum_{i=1}^N CAR_i}{N \times std\ dev}$$

where $i = [1, 2, \dots, 402]$, $N = 402$, and where std dev corresponds to the standard deviation of CAR_i .

The test statistic we use to test whether the ACAR is statistically significant different from zero is (null hypothesis):

¹⁴ To normalize a CARs series, we just need to divide each car by the standard deviation of the series.

¹⁵ For the CARs (-10, +10) series, we were forced to exclude one observation, because there were no data available for that event.

Formula 5

$$Z = ACAR_t \times N^{0.5}$$

We repeat this procedure for each event window. Appendix 3 reports the statistics we get. As we can observe, for the event window composed by the 10 days prior and the 10 days after the event, we should reject the hypothesis of significant average cumulative abnormal returns different from zero. For the other event windows, we should not reject that hypothesis. Thus, CARs for the 3 days prior and after the event, and for the days before and after the event, are statistically significant different from zero.

6. Empirical results

Now that we have the CARs series for the three event windows, we are able to run cross-sectional regressions of each CARs series on our set of explanatory variables, and test whether political appointments are capitalized by the market into equity prices, as an anticipation of future political benefits. In what follows, this empirical section is organized in three parts. The first part tests the different effects of political appointments and non political appointments on firm's value. The second part adds to the political component of an appointment the corporate component, and tests whether there are effects on firm's value. Finally, the third part tests if there are different effects on firm's value, depending on when we are dealing with an appointment that is reported for the first time, or a reappointment.

6.1. Empirical results – Political component analysis

We say that an executive has political connections when he, at some point in time prior to the day of the announcement, held a political position such as Prime Minister, Minister or Secretary of State, at least during one of the Portuguese Constitutional Governments from January, 1980 to April, 2012. Following this criterion, we define political appointment as an appointment where at least one executive with those characteristics is nominated.

Appendix 4 presents the relation between the stock returns of our sample of 46 firms and 402 appointments¹⁶, and our definitions for political and non political appointments.

We run each cumulative abnormal return, CARs (-10, +10), CARs (-3, +3), and CARs (-1, +1) on a dummy, *Political Appointment*, that capture whether an appointment is political or not. As we can observe neither the dummy, nor the constant are statistically significant whatever the event window considered. These results suggest that the market does not react to an appointment when he only knows if there are politically connected executives or not. Actually, this is a naïve definition of political connections, because investors can get access to information that allows them to go beyond than that to forecast performance changes related with such appointments. Since investors can get information about the name of the individuals that are being nominated, they can easily know which type of political filiations each executive has; they can know to what political party are the executives connected; they can react to the possibility of the political party majorly represented in the appointment be the same or not than the one that is in the Government at the moment of the appointment. In this way, a more robust analysis will imply that we introduce explanatory variables that control for these different dimensions of a political appointment.

Appendix 5 provides results on this deeper analysis. We test for the impact of political connections, but now considering a set of dummy variables that control for different political dimensions. We repeat the procedure for different event windows. The variable *Socialist Majority* takes the value 1 if the appointment is composed by politically connected executives and the majority has affiliation to Socialist Party. By the contrary, the dummy *Democratic Majority* takes the value 1 if the majority of the politically connected executives appointed are linked to the Social Democratic Party or to CDS/ PP. Variable *Balanced Appointment* controls for the situations where the number of politically connected executives linked to a party is exactly equal to the number of executives politically linked to the other party. Dummy *Ruling Party* allows

¹⁶ For the cumulative abnormal returns computed for the event window (-10, +10) we only analyzed 401 events, due to lack of data for one of the appointments.

to test whether a firm can benefit when the political appointment is majorly represented by the election winning party.

The first conclusion we can infer is that the statistical significance of the variables increases as long as we restrict the size of the event window, suggesting that the market not only does not react to an appointment with much anticipation, as well as does not capitalize the effects for so long. In column 1, we can observe that only the coefficient for *Ruling Party* is statistically significant, suggesting that when an appointment is majorly represented by board members linked to the party that is in the Government it has a negative effect on firm's value. A possible reason is that investors anticipate future leakage of private information from the firm to the Government which can be harmful for the business. As if this is not enough, investors can recognize that the politically connected executives appointed are serving first the interests of the Government than the interests of the company.

The same analysis for the event window (-3, +3) leads to more interesting results. When all the dummies are equal to 0, then the appointment is not political connected and the effect is captured by the constant. Since its coefficient is not statistically significant, we can believe that the market is indifferent to these appointments. Indeed, they neither add, nor take value to the firm. By the contrary, when politically connected executives are being nominated, the market reacts differently. Dummies *Democratic Majority*, *Balanced Appointment*, and *Ruling Party* are significant at the 5% level, and *Socialist Majority* is significant at the 1% level.

The results suggest that there is a negative effect on cumulative abnormal stock returns whenever a firm appoints to its corporate governance executives that are politically connected. The only exception is the case of a balanced political appointment. If we think on business strategy as an action that lasts in time, then it may be an added value when an appointment is composed by both parties because in this way, the firm can always benefit whatever the ruling party. Indeed, we can think on this result as being reinforced by the negative sign of dummy *Ruling Party*. When an appointment is majorly composed by politically connected executives linked to the elections winning party, next Government, it may be represented majorly by

executives linked to the opposite side of the Government. We can conclude that the market does not think only on the short-term decisions, and feels more confident when all the political scenarios are considered. The same holds true for the event window (-1, +1) as we can observe in column 1, table 10. When we are considering the day prior to the event and the day immediately after, what we can observe is that the effect of political appointments is enhanced relatively to the event window (-3, +3).

6.2. Empirical results - Political and corporate components analysis

As we said before, this study attempts to go beyond the political characteristics of an appointment. Indeed, there may be different effects on firm's value regarding the different corporate position to which an executive is appointed. Following this idea, we rank the corporate governance structure according with three different methods. The first one is based on the sum of the corporate points of the set of executives appointed; the second approach is based on the maximum score within the set of executives nominated by appointment, and the last method takes the average corporate scores of an appointment.

Appendix 6 shows the results of the regression of each CAR on a set of explanatory variables which are controlling for both political and corporate effects. The variable *sum of corporate points* tries to capture the effect of the appointments taking into account their different corporate weights. For example, it may be different for the strategy of the firm if the appointment relates to the nomination of an official accounts auditor or if it relates to the chief financial officer (CFO). The variable interacts with political dummies, *Socialist Majority*, *Democratic Majority*, *Ruling Party*, and *Balanced Appointment* to test how the corporate component relates with the political component of the nomination. For example, we can think that investors anticipate different effects when a politically connected executive is nominated as chairman of the board of the executive committee or when he is nominated as alternate corporate secretary.

In column 1 of table 11, we can observe that any variable is significant. This situation changes when we center our analysis for shorter periods surrounding the event. The results suggest that investors do not tend to react to the appointments nor with much

anticipation, nor many days after. The market seems to capitalize the appointments' effects on equity prices relatively quickly. Indeed, the same result is shown on Appendix 5, as we already analyzed.

For the window of three days prior and three days after the day of the appointment, only the constant and the variable sum of corporate points are not statistically significant. The remainder, *Balanced Appointment*sum*, *Socialist Majority*sum*, *Democratic Majority*sum*, and *Ruling Party*sum* are all statistically significant. The first one is statistically significant at the 10% level, the following two are significant at the 5% level and the last one is significant at the 1% level. For the statistically significant terms, the sign of the coefficients seems to be consistent with what happens on the previous model (appendix 5). The terms *Socialist Majority*sum*, *Democratic Majority*sum*, and *Ruling Party*sum* have a negative impact on firm's value. However, when compared to the previous case, these effects are now quieter. This means that knowing the role each politically connected executive will play in the firm allows investors to anticipate the future negative effects, and this way, capitalize that effects in a way less damaging to the firm. The term *Balanced Appointment*sum* has a positive coefficient and its effects on cumulative abnormal returns is more discrete when compared to the coefficient of *Balanced Appointment* on the previous model (column 3, table 10).

Another common behavior relates to the appointments' effect for the event window composed by the day prior and the day after the day of the event. For this regression, both sum of corporate points and the constant are not statistically significant. In average, the level of significance of the remainder variables increases, and their coefficients suggest the same negative impact we saw before.

In sum, accordingly with the previous results, we should highlight the following topics: the market does not react to an appointment, nor with much anticipation, nor many days before the event; the more closer to the day of the event, more the market internalizes the effect of the appointments; non politically connected executives are not seen by the market as drivers of value added even when the positions for which they are appointed are well known; only when the number of politically connected

executives linked to each party is in balance, the appointment's effect is positive. Otherwise, the market recognizes the political appointments as treat to the business.

To address the effect on firms' value of the corporate component of an appointment, we repeat the same regressions, but now using two different corporate measures, the *maximum corporate points* and the *average corporate points*, instead of the sum. Appendix 7 reports the results for the regression of CARs on a set of explanatory variables based on the maximum corporate points approach, and Appendix 8 reports the results for the average corporate points' method.

We can jointly analyze both tables 12 and 13, because the results reveal a common pattern. When we look to column 1, in both tables, none of the variables considered are statistically significant. The persistence of this result give us confidence about what we said previously when we were analyzing table 11. Actually, the market does not internalize the effect of an appointment with so many days of difference from the day of the event. This result is reinforced by the increasing statistical significance of the variables from the event window (-3, +3) to the event window (-1, +1). Once again, and for both models, the constant is not significant, meaning that investors do not recognize that non political connected executives can bring an abnormal return to the business. They are indifferent to such appointments. Another factor of indifference is the corporate weight of an appointment per se. Indeed, neither the *maximum of corporate points* in table 12, nor the *average of corporate points* in table 13, are statistically significant. This corporate component only reveals importance when combined with the political characteristics of the appointment. Now, as we saw in table 11, when considering the *sum of the corporate points* of an appointment, the interaction terms are all significant and the coefficients are negative with the exception of the coefficient of the variable *Balanced Appointment*max* (table 12) and *Balanced Appointment*average* (table13).

Once again, these results suggest that the market believes that is damaging for the business to appoint politically connected executives when they are majorly representing one of the two dominant parties. The same happens when the majority of the politically connected executives appointed are linked to the ruling party. By the

contrary, investors recognize that a balance between the two parties is crucial to add value to the firm.

The persistence of same results from table 11 to table 13 leads us to confidently conclude that the market is indifferent to a non political appointment, whatever its composition as well as its corporate weight. By the reverse, when the market has information such that it can distinguish among the political appointments, which appointments are majorly linked to a specific party and which appointments are linked to the ruling party, investors anticipate future damages to the business, and the consequence is a negative abnormal return for the period surrounding the event. However, this effect can be relief if the investors know what role those politically connected executives will play in the corporate structure of the firm. These results are not consistent with the initial assumption we made. In the beginning of this study, and following the international literature on board members' turnovers, we set the hypothesis that when a politically connected executive is appointed as a board member or as a top manager, markets anticipate future political benefits to the firm, such as privileged access to information, reduced uncertainty and reduced transaction costs, and (indirect) participation on the regulatory process. In this way, equity prices of the firm rise, generating positive abnormal returns.

6.3. Empirical results – The difference between the first appointment and a reappointment

When a firm appoints an executive to become a top manager or a board member, the existing board has the opportunity to appoint a successor with greater ability than the departing member. However, according with some authors (Borokhovich et al, 1996, and Chan, 1996) investors can react differently regarding when it is an insider¹⁷ appointment or an outsider appointment. They suggest that the appointment of an executive from outside the firm is understood by the market as more beneficial than an inside appointment. They argue that it is more costly to appoint an outsider, thus, a firm will not appoint an outsider unless the incremental improvement relative to an insider candidates is expected.

¹⁷ We consider as insider an individual that already belongs to the corporate governance of the firm. By the contrary, an outsider is an executive which appointment occurs for the first time.

Following this idea, we decide to test if there are different expected abnormal returns depending on whether it is an appointment of an outsider (appointment) or an appointment of an insider (reappointment)¹⁸. To address this purpose, we look to our appointments sample, and we take only those appointments in which the chairman of the board of directors is announced. Then, for each firm, we assume the starting point of this analysis the first time the chairman of the board of directors is appointed. According with this criterion, we can distinguish which executives within the appointments considered, those that are being nominated for the first time and those that are being reappointed. After that, we repeat the same procedures we already presented in section 6.1.. Appendix 9 reports the results we get.

The variable *First Appointment* is equal to 1 when the majority of the executives are appointed for the first time. It takes the value 0 when the majority are executives that are being reappointed. As we can observe, the variable *First Appointment* is not statistically significant whatever the event window considered. This suggests that investors are indifferent to this kind of distinction. Once again, the market only reacts to the political components of an appointment, and this reaction is more evident as the day of the event gets closer. In column 3, the number of statistically significant variables is higher than the one for column 1 and 2. In column 3, both *Socialist Majority* and *Ruling Party* are statistically significant at the 1% level. The variables *Balanced Appointment* and *Democratic Majority* are significant at the 5% and 10% level, respectively. The constant is not significant meaning that the market neither reacts to non political appointments, nor to reappointments. The signs for *Socialist Majority*, *Democratic Majority*, and *Ruling Party* are once again negative, meaning that investors do not view these appointments as good news for firm's performance improvements. Only the coefficient of *Balanced Appointment* is positive, suggesting that investors presage good news, when the politically connected executives appointed linked to each party, independently of being nominated for the first time or reappointed, are represented in the same proportion.

¹⁸ For simplicity purpose, in what follows, we will refer to an outsider appointment simply as an appointment, and to an insider appointment as a reappointment.

7. Conclusions

This study attempts to explore whether the announcement of politically connected executives can have impact on firm's value. The framework is the Portuguese economy which has a strong legal system, developed financial markets, and low levels of political corruption. To address this challenge, we set the hypothesis that if political connections matter, then the appointment of a politically connected executive as a top manager or board member will lead to an increase in firm's value which will be recognized by the market and capitalized into equity prices as an anticipation of future political benefits, such as: easier access to debt financing; lower taxes; power to influence the laws under which the firm operate; possibility of winning government contracts, and stronger market power.

To perform this goal, we run several cross sectional regressions of the cumulative abnormal returns for three different event windows, on a set of explanatory variables which control for the political component and corporate weight of an appointment.

The results we get are robust and consistent across all the analysis we perform, and they lead us to reject our initial hypothesis that politically connected executives add value to the firm.

In average, investors react negatively to a political appointment, unless the appointment illustrates appropriate balance power. When the majority of the politically connected executives are linked to one of the dominant parties in Portugal, that is, to the Socialist Party or to the Social Democratic Party, and CDS/ PP, then investors anticipate that these political ties will jeopardize firm's value. The same holds when the party majorly represented in the appointment is the ruling party. These negative effects are more pronounced as we get closer to the day of the appointment.

These pervasive effects that political connections have on firm performance may be associated with the conflict of interests between the Government and the private sector. Investors can see those executives as a Government channel for firms to pursue political objectives. In this way, political ties can lead to a misallocation of investments. Furthermore, they can be recognized as an increase in corruption

activities which can be costly when firms operate in a scenario where such practices are illegal and severely punished.

When we test for the corporate weight of each appointment, we find that this information only reveals significance when combined with the political component of the appointments. In average, investors tend to alleviate the pervasive effect of political appointments on firm's performance when they know which role will those politically connected executives play in the corporate structure of the firm, and what is the level such positions occupy in the hierarchy of the corporate governance.

Despite our conclusions, we should stress that even though stock price reactions around the time of executives' appointments reflect investors' expectations regarding the future performance of the firm, they do not reveal the outcome themselves.

Another important limitation of this study relates to the fact that in Portugal does not exist any structure pioneered online information that allow us to get access to premium information sources, like Lexis-Nexis¹⁹ in the United States of America (USA). In this way, it is impossible for us to control for possible leakage of information regarding an appointment. For instance, we can believe that an appointment is preceded by some rumors. However, we have no tools to identify when those rumors started coming out in press. In order to bypass this limitation, we were forced to assume that there is no leakage of information surrounding an appointment. As a consequence of this limitation, the unique contribution of our study is in showing that the impact of political connections on firm's value is more likely to be due to the investors' expectations that these connections provide firms with political influence.

Finally, we should stress that the evidence presented in this study, although a pioneer in Portugal, opens several doors for future research. In particular, it will be interesting to explore whether the impact on stock price may not only be due to the fact that a board member is politically connected, but also to his expertise. For instance, we can believe that the contribution to a construction firm of a politically connected executive whose political past is linked to the construction sector and real estate tend to be

¹⁹ We can consult the official website of Lexis-Nexis following this link: <http://www.lexisnexis.com/en-us/about-us/about-us.page>

higher than the contribution of a politically connected executive whose political past is linked to the education sector.

8. Appendices

Appendix 1

Table 2 – Corporate Governance structure and corporate points

We look the corporate structure of a firm, and we give to each position a score based on the specific functions and contributions of that position to the firm. To do that, we define a scale from 0 to 10, and we look to each firm's corporate governance. After that, we try to establish a criterion such that it is the most transversal possible to all the 46 firms.

Corporate Governance Structure	Corporate Position	Points
Board of Directors	Chairman - Executive	10
	Chairman - Non Executive	9
	Deputy Chairman - Executive	8
	Deputy Chairman - Non Executive	7
	Member - Executive	6
	Member - Non Executive	5
	Alternate Member - Executive	4
	Alternate Member - Non Executive	3
Fiscal Board Management Team	Chairman - Executive	7
	Chairman - Non Executive	6
	Deputy Chairman - Executive	6
	Deputy Chairman - Non Executive	5
	Member - Executive	4
	Member - Non Executive	3
	Secretary	2
	Alternate Secretary	1
Board of General Meeting	Chairman - Executive	6
	Chairman - Non Executive	5
	Deputy Chairman - Executive	5
	Deputy Chairman – Non Executive	4
	Member	4

	Alternate Member	3
	Secretary	2
	Alternate Secretary	1
Executive Committee	Chairman (CEO)	9
	Deputy Chairman (CFO)	7
	Member	5
	Alternate Member	4
Audit Committee	Chairman	4
	Member	3
	Alternate Member	2
Remunerations Committee Advisory Council Technologies Committee Corporate Governance Committee	Chairman	3
	Member	2
	Alternate Member	1
Others	Market Relations Representative	2
	Official Accounts Auditor	2
	Alternate Official Accounts Auditor	1
	Corporate Secretary	2
	Alternate Corporate Secretary	1

Source: This numbers are based on author's methodology to address the corporate governance hierarchy of a firm.

Appendix 2

Table 4 – Valuation of each executive in accordance with his political past (procedure 1)

We define a politically connected executive as an executive who held, at any day prior to the day of the appointment, a political position such as Prime Minister, Minister or Secretary of State. Considering this political hierarchy, we decide to give to each political position a score, in a range from 0 to 3. The score 0 relates to the cases when the executive nominated has not a political past.

Executives		Weight
Political connected executive	Prime Minister	3
	Minister	2
	Secretary of State	1
Non political connected executive		0

Source: These numbers are based on author's methodology to address the political hierarchy.

Appendix 3

Table 8: Statistically significance of CARs

Assuming that CARs series are independent and identically distributed, we perform a statistical test in order to check the significance of the CARs. The null hypothesis is that the average cumulative abnormal returns are statistically significant different from 0, so then the CARs are. The Z stat follows a normal distribution. Robust p-values are indicated in parentheses. Symbols *, **, and *** denote statistical significance at the 10%, 5%, and 1% level, respectively.

	CAR (-10, +10)	CAR (-3, +3)	CAR (-1, +1)
Z stat	10.01	0.31*	-0.68*

Source: Author's calculations based on the CARs series.

Appendix 4

Table 9: Political connections and non political connections

We look to each firm that exchanges in the Euronext Lisbon, and we collect all the information related with the board members' appointments these firms have done from January, 2000 to April, 2004. The appointments data is taken from the official website of Comissão do Mercado de Valores Mobiliários (CMVM). We were forced to exclude 1 of the 47 firms that exchange in the Euronext Lisbon, because there is no information available on that topic. An appointment is classified as political (*Political Appointment*=1) if within the set of executives appointed, there is at least one executive that at any day prior to the day of the appointment held a political position such as Prime Minister, Minister or Secretary of State. For this purpose, we analyze the composition of the Portuguese Governments from January, 1980 to April, 2012. This data is taken from the Portuguese Government official website. The cumulative abnormal returns (CARs) used are all normalized, because since we are using daily data, this procedure help us to get more accurate results. The estimation window is from 250 days prior to the event to one day before the event. Robust p-values are indicated in parentheses. Symbols *, **, and *** denote statistical significance at the 10%, 5%, and 1% level, respectively.

VARIABLES	(1) CARs (-10, +10)	(2) CARs (-3, +3)	(3) CARs (-1, +1)
Political Appointment	0.000 (0.141)	-0.241 (0.727)	-0.690 (0.559)
Constant	0.000 (0.225)	-0.132 (0.765)	-0.386 (0.676)
Observations	401	402	402
R-squared	0.005	0.000	0.000

Table 10: Political connections and non political connections – Different political dimensions

The table displays results from regressions on daily CARs on political variables, as defined in section 4.2.. CARs were obtained using a estimation window of 250 days. The dataset comprises all appointments of board members made between January, 2000 and April, 2012 by firms listed in Euronext Lisbon. The appointments data is taken from the official website of Comissão do Mercado de Valores Mobiliários (CMVM). We excluded one firm for which data was not available. An appointment is classified as political if any of the appointed board members held a political position after Jan-1980, and prior to the day of the appointment. We obtain the political data from the Portuguese Government official website. Robust p-values are indicated in parentheses. Symbols *, **, and *** denote statistical significance at the 10%, 5%, and 1% level, respectively.

VARIABLES	(1) CARs (-10, +10)	(2) CARs (-3, +3)	(3) CARs (-1, +1)
Socialist Majority	0.000 (0.237)	-6.380*** (0.00634)	-10.99*** (0.00143)
Democratic Majority	0.000 (0.237)	-6.181** (0.0197)	-8.698** (0.0199)
Balanced Appointment	0.000 (0.185)	3.076** (0.0217)	5.633*** (0.00660)
Ruling Party	-6.804* (0.0666)	-2.406** (0.0125)	-5.455*** (0.000263)
Constant	0.000 (0.227)	-0.132 (0.766)	-0.386 (0.678)
Observations	401	402	402
R-squared	0.007	0.008	0.007

Appendix 6

Table 11: Political and corporate dimensions of an appointment – The sum effect

The table displays results from regressions on daily CARs on a set of corporate and political variables, as defined in section 4. The corporate variable observed in this table is the *sum of corporate points*. CARs were obtained using an estimation window of 250 days. The dataset comprises all appointments of board members made between January, 2000 and April, 2012 by firms listed in Euronext Lisbon. The appointments data is taken from the official website of Comissão do Mercado de Valores Mobiliários (CMVM). We excluded one firm for which data was not available. An appointment is classified as political if any of the appointed board members held a political position after Jan-1980, and prior to the day of the appointment. We obtain the political data from the Portuguese Government official website. Robust p-values are indicated in parentheses. Symbols *, **, and *** denote statistical significance at the 10%, 5%, and 1% level, respectively.

VARIABLES	(1) CARs (-10, +10)	(2) CARs (-3, +3)	(3) CARs (-1, +1)
Sum of corporate points	0.000 (0.294)	-0.013 (0.428)	-0.017 (0.524)
Socialist Majority_sum	0.000 (0.212)	-0.067** (0.0221)	-0.120*** (0.00476)
Democratic Majority_sum	0.000 (0.212)	-0.07** (0.0242)	-0.098** (0.0248)
Ruling Party_sum	0.000 (0.379)	-0.025*** (0.00629)	-0.063*** (0.000169)
Balanced Appointment_sum	0.000 (0.247)	0.038* (0.0549)	0.066** (0.0248)
Constant	0.000 (0.306)	0.131 (0.801)	0.025 (0.982)
Observations	401	402	402
R-squared	0.022	0.007	0.009

Appendix 7

Table 12: Political and corporate dimensions of an appointment – Maximum effect

The table displays results from regressions on daily CARs on a set of corporate and political variables, as defined in section 4. The corporate variable observed in this table is the *maximum of corporate points*. CARs were obtained using an estimation window of 250 days. The dataset comprises all appointments of board members made between January, 2000 and April, 2012 by firms listed in Euronext Lisbon. The appointments data is taken from the official website of Comissão do Mercado de Valores Mobiliários (CMVM). We excluded one firm for which data was not available. An appointment is classified as political if any of the appointed board members held a political position after Jan-1980, and prior to the day of the appointment. We obtain the political data from the Portuguese Government official website. Robust p-values are indicated in parentheses. Symbols *, **, and *** denote statistical significance at the 10%, 5%, and 1% level, respectively.

VARIABLES	(1) CARs (-10, +10)	(2) CARs (-3, +3)	(3) CARs (-1, +1)
Max of corporate points	0.000 (0.345)	-0.016 (0.919)	-0.105 (0.758)
Socialist Majority*max	0.000 (0.193)	-0.659** (0.0165)	-1.129*** (0.00288)
Democratic Majority*max	0.000 (0.193)	-0.603** (0.0404)	-0.858** (0.0299)
Balanced Appointment*max	0.000 (0.150)	0.320** (0.0386)	0.588*** (0.00794)
Ruling Party*max	0.000 (0.594)	-0.251** (0.0112)	-0.579*** (0.000329)
Constant	0.000 (0.454)	-0.039 (0.972)	0.241 (0.925)
Observations	401	402	402
R-squared	0.013	0.007	0.007

Appendix 8

Table 13: Political and corporate dimensions of an appointment – The average effect

The table displays results from regressions on daily CARs on a set of corporate and political variables, as defined in section 4. The corporate variable observed in this table is the *average of corporate points*. CARs were obtained using an estimation window of 250 days. The dataset comprises all appointments of board members made between January, 2000 and April, 2012 by firms listed in Euronext Lisbon. The appointments data is taken from the official website of Comissão do Mercado de Valores Mobiliários (CMVM). We excluded one firm for which data was not available. An appointment is classified as political if any of the appointed board members held a political position after Jan-1980, and prior to the day of the appointment. We obtain the political data from the Portuguese Government official website. Robust p-values are indicated in parentheses. Symbols *, **, and *** denote statistical significance at the 10%, 5%, and 1% level, respectively.

VARIABLES	(1) CARs (-10, +10)	(2) CARs (-3, +3)	(3) CARs (-1, +1)
Average of corporate points	0.000 (0.601)	0.0576 (0.805)	0.017 (0.975)
Socialist Majority*average	0.000 (0.238)	-1.035** (0.0195)	-1.755*** (0.00948)
Democratic Majority*average	0.000 (0.241)	-1.057** (0.0245)	-1.302* (0.0714)
Ruling Party*average	0.000 (0.582)	-0.403** (0.0132)	-0.858*** (0.00301)
Balanced Appointment*average	0.000 (0.189)	0.498** (0.0408)	0.886** (0.0223)
Constant	0.000 (0.168)	-0.369 (0.773)	-0.470 (0.875)
Observations	401	402	402
R-squared	0.009	0.007	0.006

Appendix 9

Table 14:

The table displays results from regressions on daily CARs on a set of political variables, as defined in section 4. CARs were obtained using an estimation window of 250 days. The dataset comprises only the appointments of board members in which the chairman of the board of directors is nominated. After that, we distinguish between appointments or reappointments. Once again, we consider only appointments made between January, 2000 and April, 2012 by firms listed in Euronext Lisbon. The appointments data is taken from the official website of Comissão do Mercado de Valores Mobiliários (CMVM). An appointment is classified as political if any of the appointed board members held a political position after Jan-1980, and prior to the day of the appointment. We obtain the political data from the Portuguese Government official website. In the end, we get a sample of 39 firms and a total of 103 appointments. Robust p-values are indicated in parentheses. Symbols *, **, and *** denote statistical significance at the 10%, 5%, and 1% level, respectively.

VARIABLES	(1) CARs (-10, +10)	(2) CARs (-3, +3)	(3) CARs (-1, +1)
First Appointment	0.000 (0.327)	-0.402 (0.711)	-1.574 (0.328)
Socialist Majority	0.000 (0.361)	-6.691 (0.109)	-18.29*** (0.00647)
Democratic Majority	0.000 (0.350)	-4.593 (0.256)	-12.56* (0.0711)
Balanced Appointment	0.000 (0.336)	4.001* (0.0784)	9.635** (0.0121)
Ruling Party	0.000 (0.355)	-4.257*** (0.00684)	-10.40*** (0.000139)
Constant	0.000 (0.327)	0.147 (0.849)	0.802 (0.509)
Observations	102	103	103
R-squared	0.019	0.029	0.097

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