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Do business groups affect corporate cash holdings? Evidence from a transition economy☆

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ABSTRACT

We examine whether business groups' influence on cash holdings depends on ownership. Group affiliation can increase firms' agency costs or benefit firms by providing an internal capital market, especially in transition economies characterized by weak investor protection and difficult external capital acquisition. A hand-collected dataset of Chinese firms reveals that group affiliation decreases cash holdings, alleviating the free-cash-flow problem of agency costs. State ownership and control of listed firms moderate this benefit, which is more pronounced when the financial market is less liquid. Group affiliation facilitates related-party transactions, increases debt capacity and decreases investment-cash-flow sensitivity and overinvestment. In transitional economies, privately controlled firms are more likely to benefit from group affiliation than state-controlled firms propped up by the government.

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1. Introduction

This paper investigates the effect of business groups on firms' cash policies and whether it depends on ownership structure. A business group is a set of legally independent firms bound together by formal and informal ties (for an overview of business groups, see Khanna and Yafeh, 2007). This unique organizational form is internationally widespread, especially in transition economies. For instance, Claessens et al. (2002) find that in eight of the nine Asian countries they study, the top fifteen family groups control more than 20% of the listed corporate assets. In particular, up to the end of 2006, Chinese business groups contributed above 60% of the nation's industrial output (Sutherland, 2009). Despite their significant contribution to national economies, the general understanding of business groups in emerging countries has thus far been inadequate.

The literature suggests two competing explanations of how business groups affect corporate cash holdings. A predominant view in corporate finance is based on the free-cash-flow hypothesis, which posits that in the presence of agency costs of managerial discretion, management has incentives to hold excess cash for its own objectives at shareholders' expense (Jensen, 1986). The complicated ownership and organizational structure of business groups result in a higher level of information asymmetry than seen in standalone firms, which inevitably exacerbates the agency conflicts between managers and shareholders. Alternatively, business group affiliation benefits firms by forming an internal capital market. The precautionary motive hypothesis put forth by Keynes (1936) suggests that in the presence of an internal capital market, business group affiliates tend to hold less cash due to a lower level of financial constraints (Schiantarelli and Sembenelli, 2000). Taken together, the net effect of business groups on cash holdings depends on which role of the business group dominates the other. This study explores business groups in China and aims to contribute to the current debate over their role in emerging economies.

Transition economies like China offer a suitable research setting in which to study the costs and benefits of business groups for two reasons. First, China is characterized by the coexistence of tremendous economic achievements and an underdeveloped institutional environment. As the largest emerging economy, China has experienced unprecedented economic growth during the past three decades. However, the country's investor protection is among the worst worldwide. Allen et al. (2005) suggest that China ranks the lowest in terms of investor protection among the countries included in a study by La Porta et al. (1998). External financing in the country can be very costly or even unavailable (Ayyagari et al., 2010). In such a context, business groups may serve extensive governance functions by creating an internal capital market (He et al., 2013) and enhancing intra-group guarantees and financing flexibility (Chang and Hong, 2000). Second, despite its transition from a centrally planned economy to a market-oriented economy, China has maintained a state-dominated financial system in which the government has substantial influence over the allocation of financial resources (Cai et al., 2014). The state-dominated financial system usually favors state-owned enterprises (SOEs) by providing them financial support in the forms of preferential loans, state subsidies, IPO/SEO opportunities and so forth. As opposed to their SOE counterparts, non-SOEs (NSOEs) face greater difficulties accessing external finance. Thus, a business group is likely to serve as an internal capital market to mitigate the financial constraints facing NSOEs.

Our empirical findings are as follows. Using a panel of 6633 Chinese listed non-financial firms covering 2008–2011, we find that group-affiliated firms hold significantly less cash than their unaffiliated counterparts. This finding is consistent with the view that the precautionary motive of affiliated firms to hold cash is weaker due to the lower level of constraints imposed by the internal capital market. In addition, we examine whether the effects of business groups on cash holdings differ between SOEs and NSOEs. The results show that the role of business groups in decreasing cash reserves is economically and statistically more prominent among NSOEs. In subsequent analysis, we exploit an exogenous shock to the credit supply as a result of tight monetary policy during 2010–2011. As expected, we find strong evidence that the decrease in credit supply due to the monetary policy change strengthens the relationship between business groups and cash holdings and that this relationship is more pronounced among NSOEs.

We perform several additional analyses to shed light on the mechanisms through which business groups can mitigate capital constraints. First, we examine whether group affiliates are involved in more related-party transactions. Consistent with Jia et al. (2013), we find a positive relationship between business groups and the amount of related-party transactions, providing direct evidence of the internal capital market mechanism

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