Finance Research Letters 18 (2016) 328–333

Contents lists available at ScienceDirect

Finance Research Letters

journal homepage: www.elsevier.com/locate/frl

Political connections, overinvestments and firm performance: Evidence from Chinese listed real estate firms

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ARTICLE INFO

Article history:
Received 10 February 2016
Revised 7 May 2016
Accepted 14 May 2016
Available online 16 May 2016

JEL classification:
G32
G34
G38

Keywords:
Political connection
Real estate
Overinvestment
Firm performance

ABSTRACT

Using a sample of 103 listed real estate firms from 1998 to 2012, this paper examines the influence of firms' political connections on external financing, corporate investment, and financial performance. The results indicate that political connections are negatively related to return on assets. Moreover, firms with stronger connections are financed with more long-term bank loans and are more likely to overinvest, which partially explains the puzzle of adverse effect of political connections on performance. Taken together, our results suggest that cultivating political connections could be a risky investment and may not always pay off.

1. Introduction

Having good friends in government is valuable social capital for businessmen. A couple of articles have found that closer connections with government are associated with better firm performance (Boubakri et al, 2012 Boubakri et al., 2012; Faccio, 2006). However, other studies have provided conflicting evidences that politically connected firms underperform (Faccio, 2010; Fan et al., 2007). As the extant findings are mixed, further investigation on potential benefits and costs of political connections is still warranted. While extensive studies have been done in political connection context, few studies have examined the real estate industry. We intend to investigate Chinese real estate industry because in this industry the influence of government is decisively important. For example, permissions and licenses issued by government are required for all real estate projects, and land supply is strictly controlled by the government because all urban land is state-owned. Moreover, the real estate development in China relies on external financing mainly in the form of bank loans. It is well known that most major Chinese banks are closely connected to the government. A good relationship with the government can help firms acquire easier access to these precious resources such as lands, capital, and licenses. Thus, the Chinese real estate industry provides a unique and ideal institutional setting to study the effects of political connection on firm operations.

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http://dx.doi.org/10.1016/j.frl.2016.05.009
1544-6123/

Our paper contributes to the extant literature in several ways. First, unlike prior research that focus on CEO or chairman only and uses a dummy variable to measure a firm's political connections, this study constructs a composite score measure based on the relative strength of political connections of all chief officers and board members. We contend that our composite score measure is superior to indicator measures because it incorporates political background of all members in the top management team. Furthermore, our measure also considers the relative strength of individual's political connections, as the score that we assign to a person is a value based on his highest political rank achieved in Chinese political system.

Our second contribution is that this paper is the first to document the evidence of a causality relation between political connections and corporate overinvestments. We find that firms with stronger political connections experience lower return on assets compared to other firms. We investigate further and find that firms with stronger political ties are more likely to overinvest their capitals. Thus, the finding that political connections are closely related to overinvestments partially explains the puzzle of the adverse effect of political connections on firm performance found in the extant literature and in this paper as well. The finance literature has a consensus that cash-rich, entrenched and overconfident managers tend to overinvest corporate resources by undertaking negative NPV projects such as unsound mergers and acquisitions that destroy firm value (Harford, 1999; Jensen 1986; Malmendier & Tate, 2005, 2008; Stulz 1990). The current study extends the literature by proposing that political connections can cause managerial overconfidence and that intervention from politicians can lead to corporate overinvestments, too.

2. Data and sample

Our final sample includes 103 real estate firms in China that are listed in the Shanghai Stock Exchange and Shenzhen Stock Exchange, covering the period of 1998–2012. Data are retrieved from the China Stock Market & Accounting Research (CSMAR) database. We use long-term and short-term loans scaled by total assets to measure firms' capability to obtain financial support from banks. Firm profitability is measured by return on asset (ROA). The set of control variables include sales, assets, cash, etc. The average market capitalization of our sample firms at the end of 2012 was 7.99 billion Chinese yuan, and the smallest (largest) firm was valued at 0.57 (97.97) billion yuan. In China, the development of residential property accounts for the majority of real estate projects, and most real estate firms diversify their business geographically. For example, as one of the leading real estate companies, Wanke has received most of its revenues from residential property development. According to its annual report in 2012, Beijing, Guangzhou and Shenzhen areas contributed about 60% of its revenue, while Shanghai and Chengdu areas contributed roughly the remaining 40%.

Based on China's hierarchical rank system, we categorize political ranks into seven categories in ascending order and assign a rank score from one to seven to each category, respectively. For instance, a rank score of seven is assigned to Fu Bu (ministerial level) while a value of one is assigned to the lowest political rank, e.g., the clerk. And then, for each firm and each fiscal year, we read profiles of every board director and chief officer to identify his/her highest political rank with the corresponding score assigned. Next, we add individuals' rank scores together to obtain an aggregate political connection score, *PC*.[1]

3. Results and discussion

3.1. PC effects on loans

We estimate the following fixed-effect panel regression model:

$$\text{Loans} = f(\text{Political connection}, X), \tag{1}$$

where the dependent variables are *Short-term Loan* and *Long-term Loan*, respectively, and X is a vector of lagged control variables. The first column in Table 1 reports the results of *Short-term Loan* regression. We do not observe significant impact of *PC* on *Short-term Loan*. In contrast, the effect of *PC* on *Long-term Loan* reported in the second column is very significant, as the coefficient of *PC* is 0.1788 and statistically significant at the 5% level. In the real estate industry, the construction can last for years and thus long-term commercial loans are critical for real estate development. From this perspective, Chinese real estate firms do benefit from their political ties.

We attempt to alleviate the potential endogeneity problem by employing two approaches. The first approach is using firm fixed effect model. In the second approach, we use instrumental variables and run a two-stage least square regression (2SLS) as an alternative test. We select three instrumental variables for *PC*. The first variable is the distance (in kilometers) between the corporate headquarters and Beijing, the capital city of China. We pick this variable to follow Houston et al. (2014), who investigate the influence of political connections on the bank loan costs of US firms. Our second instrumental variable is an index of free market environment that measures the level of economic development at the region where the corporate headquarter is located. The third instrumental variable is an index of legal environment. Both indices are collected from Fan and Wang (2013). The intuition for using these three variables is that firms that are headquartered closer to Beijing have more opportunities to approach politicians. Meanwhile, former or retired politicians might be more willing to work or

[1] Please refer to the appendix for the classification of political ranks shown in panel A and an example of calculating political connection (*PC*) scores demonstrated in panel B.