ARTICLE IN PRESS
FINANA-00676; No of Pages 12
International Review of Financial Analysis xxx (2014) xxx–xxx
Contents lists available at ScienceDirect
International Review of Financial Analysis

How are political connections valued in China? Evidence from market reaction to CEO succession

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ARTICLE INFO

Article history:
Received 14 May 2013
Received in revised form 25 October 2013
Accepted 7 January 2014
Available online xxxx

Keywords:
Political connection
CEO turnover
China

ABSTRACT

Using a sample of listed Chinese firms between 2000 and 2010, the paper analyzes the stock market reaction to CEO succession. We document significantly positive cumulative abnormal returns when CEO succession is accompanied with increased political connections. We also show that the market reaction to political connections is significantly stronger for external successors and for poorly performing firms, while it is significantly weaker for firms in high-tech industries and firms located in more developed regions. Finally we find that political connections are valued significantly less in state owned enterprises than in privately controlled firms. Our findings suggest that Chinese investors do value political connections, and such valuation is conditioned by successor origin, prior firm performance, industry, region, and ownership structure.

1. Introduction

A growing body of literature has addressed the role of political connections in the business world. It has been shown that political connections of executives and board members help firms obtain more favorable bank loans (Firth, Lin, Liu, & Wong, 2009; Khwaja & Mian, 2005; Sapienza, 2004), easier access to equity capital (Boubakri, Cosset, & Saffar, 2012; Boubakri, Guedhami, Mishra, & Saffar, 2012; Claessens, Feijen, & Laeven, 2008; Hearn, 2012; Johnson & Mitton, 2003), lower tax rates (Faccio, 2010), preferential regulatory treatments (Bunkanwanicha & Wiwattanakantang, 2009; Faccio, Masulis, & McConnell, 2006; Johnson & Mitton, 2003), and may ultimately improve firm performance (Boubakri, Cosset, et al., 2012; Fisman, 2001). This study advances the extant literature by investigating the market response to political connections surrounding CEO succession. Specifically, we examine the stock market reaction to changing political connections as a result of CEO turnover. While a few studies have noted that political connections affect IPO underpricing and post-IPO performance of newly public firms (Fan, Wong, & Zhang, 2007; Francis, Hasan, & Sun, 2009), no research to date has explicitly investigated how shareholders may respond to changes in executives' political connections, which will be the focus of this paper.

We substantially supplement previous cross-sectional studies on the impact of political connections by implementing an event analysis method to investigate stock market performance surrounding CEO turnover. Our event study method is built on Fama (1970)'s efficient capital market argument, which posits that the movement of a firm's stock return around the event point effectively captures shareholder response to information about the event (Fama, Fisher, Jensen, & Roll, 1969). Abnormal stock price responses surrounding, in this case a CEO succession event, is a direct test of the stock market's expectation of change in future firm value caused by leadership change (Denis & Denis, 1995). That is, the add-on value of political connections signaled by CEO turnover. The event analysis method thus helps to mitigate the impact of confounding factors often associated with previous cross-sectional studies (Boubakri, Cosset, et al., 2012).

We take China as an ideal setting for our study. First, the cultivation of political connections is especially important in transitional economies such as China, where inadequate institutional support, underdeveloped investor protection legislation, overarching government interference and control, as well as weak enforcement of contracts and property rights create numerous obstacles for businesses (Allen, Qian, & Qian, 2005; Johnson, Millian, & Woodruff, 2002). As a result, building close ties to the government often becomes an effective strategic mechanism for businesses in these economies to overcome market failure (Li, Meng, Wang, & Zhou, 2008). In this respect, China provides a suitable laboratory for us to examine shareholders' response to political connections. Second, China's unique institutional contexts offer useful variations to explore the role of political connections. For example, China's economic liberalization has decentralized the political system. Governments at various levels possess policy making power within their jurisdictions, which makes it possible to capture variety and strength of political connections (You & Du, 2012). In addition, unbalanced regional development and inconsistent legal protection in China provide a natural testing ground for us to investigate how political connections may

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1057-5219/$ – see front matter
http://dx.doi.org/10.1016/j.irfa.2014.01.011

Please cite this article as: He, L., et al., How are political connections valued in China? Evidence from market reaction to CEO succession, *International Review of Financial Analysis* (2014), http://dx.doi.org/10.1016/j.irfa.2014.01.011

substitute for formal institutional structure. Finally, China's phenomenal economic development over the last few decades and its increasing importance in the global economy warrant an investigation to better understand economic consequences of political ties there.

Using a sample of public Chinese firms experiencing CEO turnovers between 2000 and 2010, we document significantly positive cumulative abnormal returns when CEO succession is associated with increased political connections. This finding is robust to alternative specifications of political connections, and controls of executive and firm characteristics. Our findings are consistent with the prediction that the Chinese stock market does value CEOs' political connections. It thus adds additional evidence to the scant empirical studies that have documented a positive performance impact of political connections in China (Francis et al., 2009; Li et al., 2008; Tu, Lin, & Liu, 2013).

We then go a step further to explore conditions leading to a more favorable market response. Our empirical results indicate that the market reaction to political connections is stronger for external successors and for poorly performing firms, while it is weaker for firms in high-tech industries and firms located in more developed regions. Our analysis also suggests that ownership structure affects market valuation of political connections. Compared with privately controlled public firms, political connections in state-owned enterprises (SOEs) are valued significantly less by the market. By explicitly investigating contingency factors that may affect benefits and costs of political connections, our results help to reconcile mixed evidence on the performance impact of political connections in China. Specifically, we attribute discrepancies in prior empirical research to their sample differences. We conclude that while political connections generally benefit privately controlled firms (Firth et al., 2009; Li et al., 2008; Tu et al., 2013), the impact on SOEs may be negligible or even negative due to a larger degree of government exploitation and interference (Berkman, Cole, & Fu, 2010; Fan et al., 2007; Hung, Wong, & Zhang, 2012).

To sum up, our core thesis is that the Chinese stock market does appreciate executives' political connections. Moreover, the market response to political connections is affected by such moderators as ownership structure, successor origins, prior firm performance, industry and regional characteristics. The remainder of the paper is organized as follows. Section 2 develops our hypotheses. Section 3 describes data and methods. We present our results in Section 4 and provide a discussion and a conclusion in Section 5.

2. Theoretical background and hypotheses development

2.1. Political connections and shareholder reaction

In developing economies such as China, the state has strong control of key resources, and the legal system for property rights protection and contract enforcement is typically much weaker than those of developed nations (Allen et al., 2005; Cull & Xu, 2005). Under these circumstances the cultivation of political connections becomes an important tool for firms to overcome market failure (Li et al., 2008). Building political connections is also important because Chinese culture values interpersonal connections and networking in business dealings, or *Guanxi* in the Chinese term. Xin and Pearce (1996) suggest that such personal connections substitute for formal institutional support and are particularly crucial for executives in countries without strong legal and regulatory frameworks.

CEO turnover signals to the market that new strategic initiatives are likely to be taken by incoming CEOs. As a result, investors may perceive the announcement of a leadership change as an indication of the firm's future direction that may improve future cash flow and reduce systematic risk (Denis & Denis, 1995). An appointment of a politically connected CEO indicates to the market that the firm is likely to build stronger ties to the government in the future. If investors appreciate the value of political connections, we shall expect that the stock market would react favorably when CEO turnover results in added political connections to the firm.

Political connections are particularly valuable for privately-controlled firms. Nee (1992) illustrates that Chinese SOEs typically receive much more favorable treatments and resource allocations from the government compared to privately controlled firms. To offset such discriminatory treatments and to enhance their market competitiveness, Chinese private firms often have to rely on connections with government authorities to secure bank loans, circumvent government regulations, and obtain favorable tax deductions (Firth et al., 2009; Li et al., 2008). Political connections thus enable these privately controlled firms to gain access to government dominated channels of resource allocation and dispersion, and overcome ineffective factor markets and ambiguous property rights.

In contrast, political connections in SOEs may be a double-edged sword. Fan et al. (2007) and Hung et al. (2012) suggest that political connections in Chinese SOEs are associated with intensified government intervention in business, so called "grabbing hands" (Frye & Shleifer, 1997; Shleifer & Vishny, 1998). Managers and board members in these firms are often incompetent bureaucrats with private agenda ranging from seeking future political promotion to financial kickbacks from business transactions (Conyon & He, 2011; Tu et al., 2013). Moreover, the government as a controlling shareholder often engages in self-serving tunneling or pursues social objectives at the expense of other minority shareholders (Berkman et al., 2010; Jiang, Lee, & Yue, 2010). As a result, political connections in SOEs may actually impair instead of enhance shareholder value. We thus conjecture that shareholders' reaction to political connections is more positive in non-SOEs than in SOEs.

2.2. Contingent factors of political connections

2.2.1. Political connections and successor origin

The impact of a new leader on the future value of a firm is influenced by the origin of the successor. Inside successors typically represent strategic stability and continuity, while outside successors often initiate more drastic changes in mission, strategy, and personnel issues (Friedman & Singh, 1989). As a result, an external successor with political connections is more likely to utilize his/her close relationship with the government to implement new strategic initiatives, while an inside successor tends to maintain the status quo. From the information point of view, the appointment of an outside successor constitutes a significant addition to the firm's current human capital and social capital, while the contribution of an inside successor is limited. If the market takes this into account, we shall expect that the market response to political connections is more favorable when the successor is external than when the successor is internal.

2.2.2. Political connections and prior firm performance

Chang and Wong (2009) argue that inferior firm performance is more likely to prompt newly appointed CEOs to take actions to improve firm value. In contrast, CEO turnover in better performing firms is often associated with non-performance related reasons. They consequently find that Chinese SOEs experiencing financial loss are associated with an improvement in post-turnover profitability, while such profit improvement is not observed in profitable firms. You and Du (2012) further suggest that the impact of political connections on firm performance is stronger in under-performing firms. They argue that poorly performing firms are more likely to utilize their political connections to obtain favorable government treatments due to a larger pressure from shareholders to improve firm performance (You & Du, 2012). In addition, the government is more likely to provide need-based financial subsidies and support to under-performing connected firms. Using a global sample, Faccio et al. (2006) document that politically connected firms are more likely to be bailed out in case of economic distress compared to their non-connected peers. Their analysis also indicates

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