Journal of Financial Economics 111 (2014) 111–136

Contents lists available at ScienceDirect

Journal of Financial Economics

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

Politicians and the IPO decision: The impact of impending political promotions on IPO activity in China ☆

Joseph D. Piotroski [a,*], Tianyu Zhang [b]

[a] Stanford University, USA
[b] The Chinese University of Hong Kong, Hong Kong

A R T I C L E   I N F O

Article history:
Received 13 February 2013
Received in revised form
10 June 2013
Accepted 8 July 2013
Available online 26 October 2013

JEL classification:
G32
G34
D72
D78

Keywords:
Political promotion
Initial public offering
Privatization
Political connection
China

A B S T R A C T

This paper shows that incentives created by the impending turnover of local politicians can accelerate the pace of initial public offering (IPO) activity in certain politicized environments. Focusing on China, we exploit a research setting where politicians are rewarded for capital market development, firms rely on political connections for access to capital, rent-seeking behavior is rampant, and the objectives of the state might not be to maximize capital market efficiency. We find that the rate of exchange eligible firms engaging in an IPO temporarily increases in advance of impending political promotion events. This effect holds for both state-owned and non-state-owned entities. For state-owned firms, the effect is strongest in those provinces where the politicians are more likely to be rewarded for market development activity. For non-state-owned firms, the temporary increase in IPO activity appears to be (rationally) opportunistic in nature, with the effect stronger around events more likely to disrupt the firms' political connections. Promotion period IPOs underperform non-promotion period IPOs in terms of both future financial performance and long-run stock returns, have controlling shareholders who retain a larger fraction of the company, and are more likely to divert proceeds away from their intended use after the offering.

1. Introduction

This paper examines whether incentives created by the impending turnover of local politicians can accelerate the pace of initial public offering (IPO) activity in certain politicized environments. Focusing on China, we exploit a research setting where politicians are rewarded for capital market activity, firms rely on political connections for access to capital, politicians engage in rent-seeking behavior, and the state's objective might not be to maximize capital market or economic efficiency. Prior research shows that incumbent politicians are reluctant to privatize state assets when they face strong political competition, with the expected loss of private control benefits serving as the primary constraint (Dinc and Gupta, 2011). However, sufficiently strong countervailing incentives, such as rewards for market development activity or

☆ We would like to thank Ray Ball, Anne Beyer, Luzi Hail, Bin Ke, Charles Lee, Tom Lys, Zach Wang, Joseph Weber, T. J. Wong, Jerry Zimmerman and workshop participants at the Chinese University of Hong Kong's Inaugural Conference on China Institutions, Governance and Accounting, the 2012 Stanford Accounting Summer Camp, Northwestern University (Kellogg School of Management), the University of Chicago, the 2013 INSEAD accounting symposium, the 2013 Kenan-Flager Business School, University of North Carolina at Chapel Hill, Global Issues in Accounting Conference, and the 2013 Chinese Accounting Professors in North America (CAPANA) research conference for helpful suggestions and comments on this project. We would like to acknowledge the financial support of the Chinese University of Hong Kong's Center for Institutions and Governance. Joseph D. Piotroski would like to acknowledge the financial support of Stanford University Graduate School of Business' Center for Global Business and the Economy. We would like to thank Gang Zhao for research assistance.

* Corresponding author.
E-mail address: jpiotros@stanford.edu (J.D. Piotroski).

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http://dx.doi.org/10.1016/j.jfineco.2013.10.012

horizon-induced agency conflicts, can reverse the relation between politician turnover and privatization decisions. Prior research also shows that the IPO decisions of non-state-owned firms reflect a trade-off of the firm's external financing needs, market conditions, and other costs or benefits of being a private versus public company. However, in many settings, including China, access to external capital is dependent upon the existence of strong political connections (Chen and Yuan, 2004; Khwaja and Mian, 2005). Because political turnover can disrupt existing political connections, affected firms have a heightened incentive to prematurely go public. The economic consequence is a wave of low quality offerings (among both state-owned and non-state-owned companies) in advance of anticipated political turnover events.

We test these arguments by exploiting novel data sets of nonpublic industrial firms and key provincial-level political promotion events in China. We focus on high level, provincial promotion events that are visible to and anticipated by economic and political agents in the province. These impending promotions, which involve the elevation of provincial party chairmen and governors to positions of greater power, create tournament-like contests for personal advancement within the provincial political and Communist Party structure, with local politicians motivated to improve their economic credentials and reputations. These promotions are also expected to disrupt existing relationships between local politicians and local firms. The anticipated loss of valuable political connections shifts incentives of firms to engage in an IPO in advance of the promotion events. Because of the planned, well-orchestrated nature of these political promotions, a time window exists over which promotion-induced incentives arise and both politicians and affected firms can make promotion-influenced decisions.

We find that the political promotion process influences the IPO decisions of Chinese firms. Unlike prior studies showing that politicians prefer to delay privatization activity due to the expected loss of control benefits (Jones, Megginson, Nash, and Netter, 1999; and Dinc and Gupta, 2011), we find that the rate of IPO activity of state-owned firms temporarily increases in the period directly preceding an impending provincial level promotion event. This promotion effect is strongest in provinces where politicians are expected to be rewarded for tangible market development activity. We also find that the rate of IPO activity among non-state-owned firms increases in advance of the impending political promotion event. This temporary increase is significantly stronger in advance of promotion events that lead to greater disruptions of the firm's network of political connections. Given the importance of political connections to gain access to both external capital and investment opportunities in China, the pattern of IPO activity is consistent with non-state firms opportunistically raising capital before the expected loss of these valuable benefits.

Evidence on the post-IPO performance of promotion-period offerings supports this rationally opportunistic explanation. Promotion-period IPOs underperform non-promotion period IPOs in terms of both post-IPO fundamentals (i.e., return on sales, growth in sales, growth in earnings) and long-run stock returns, and promotion-period IPO firms are significantly more likely to divert IPO proceeds away from the use outlined in the firms' prospectuses. In addition, the controlling shareholders of non-state-owned firms listing in advance of political promotion events relinquish a smaller number of shares than the controlling shareholders of firms engaging in offerings outside these promotion periods, consistent with these opportunistic shareholders choosing less dilutive offerings due to the suboptimal timing of the event. The combined evidence suggests that non-state-owned firms engaging in an IPO in advance of political promotions are of lower quality and are prematurely accessing the capital markets.

This paper contributes to a broad literature showing that IPO and partial privatization activity is affected by incentives arising from the career concerns of local politicians and the relationships they form with entities under their control. Our results highlight that the expected relation between political incentives and the rate of IPO activity is contextually dependent upon the prevailing institutional arrangements. Unlike prior research, we show that in the presence of sufficiently strong incentives, affected firms accelerate their listing decisions in advance of political turnover for the benefit of either the local politicians or the listing firm. These results have implications for capital market development and resource allocation activity in China and the broader set of emerging market economies. First, when a politician's performance is evaluated on the basis of market development activity and listing activity can be influenced by political intervention, the politician uses the market mechanism to enhance his or her career prospects or to achieve specific government objectives, or both. Unlike other settings where politicians benefit from delaying privatization, we use a setting where political incentives accelerate privatization activity.[1] Second, if economic activity is either formally or informally influenced by political factors and government intervention (e.g., via corruption, cronyism, or political connections), the decision of non-state-owned firms to access public markets is shaped by beliefs about their ability to gain access through both official and unofficial channels. The economic consequences are firms raising capital prematurely and in the absence of credible investment opportunities, thereby distorting the allocation of scarce capital from an economic efficiency perspective.

The remainder of the paper is organized as follows. Section 2 discusses the IPO and political promotion processes in China. Section 3 outlines our research design and discusses our data. Section 4 presents our primary empirical results. Section 5 discusses the characteristics and economic consequences of promotion period IPOs.

[1] The partial privatization of Chinese state companies via an IPO is a primary market, capital-raising event for the firm and typically does diminish the politician's control of the company. As opposed to a share sale (i.e., secondary market transaction), the IPO mechanism in China increases the assets under the local politician's control (i.e., capital raised through the new share issuance) and gives the politician greater opportunity to engage in subsequent rent-seeking behavior (e.g., expropriation of new non-state minority shareholders).