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Do political connections matter in accessing capital markets? Evidence from China☆

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ABSTRACT

We analyze the influence of political connections on firms' access to capital and the ensuing effect on the cost of raising capital. Using a dataset of 413 IPOs from 2009 to 2012, we exploit a research setting where government is still highly involved with the process. We find that firms rely on political connections to reduce IPO rejection risk as a firm's political connections are positively associated with the propensity of obtaining approval for an IPO. We further find that political connections are negatively associated with the cost of IPO and connected firms appear to perform better subsequent to their IPOs.

1. Introduction

Government intervention in business activities has been a common feature of emerging markets. Through taxation, regulation, policy and so forth, governments influence various aspects of business: from output, production processes, to input such as land, energy, infrastructure, and financing (Shleifer and Vishny, 1994; La Porta et al., 1999). As a result of such influence, firms in these emerging markets often find it difficult to access external capital such as bank loans, which are largely reserved for state-owned enterprises (SOEs), or are subject to heavy government regulation (Johnson et al., 2000) which result in similar constraints. Competition for

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external financial resources in these emerging markets thus often involves non-price mechanisms such as building relationships with bankers, government officers and politicians (Allen et al., 2005; Güçbilmez, 2015).

A variety of literature has argued that political connections bring value to firms in various ways, ranging from the firms' terms of borrowing, market valuation, and long-term performance, to successfully competing for government contracts (Khwaja and Mian, 2005; Faccio, 2006; Fisman, 2001; Fan et al., 2007). The evidence for how political connections affect the process of obtaining arguably the best form of external financing, the public market, however, is still limited.

This paper attempts to fill this gap by investigating newly listed firms in China to examine the relation between political connections and the process of going public. Focusing on China, where the government plays a uniquely predominant role in the increasingly capitalist economy, is suitable for conducting this research.[1]

Before a firm is able to access public capital, it must first meet the listing requirements of an exchange. If it believes it is able to do so it will go through the process of preparing a prospectus, which generally provides the background of the company and the terms of the public offering, and that prospectus will be reviewed by the securities regulators of the relevant jurisdiction. For example in the United States, the Securities and Exchange Commission (SEC) requests that a S-1 document will be filed and the SEC will then negotiate with the firm to either approve, amend or deny the filing. In China, firms attempting to go public must obtain approval from the China Securities Regulatory Commission (the CSRC),[2] otherwise their issues cannot be listed on the stock exchange for trading. We find evidence that suggests that between 2009 and 2012, one in six IPO applications failed to pass the CSRC's screening.[3] Being rejected by the regulator approving the prospectus is very costly for firms, not only in terms of the foregone benefits of the projects the additional capital would have funded, but also the direct cost of preparing the firm for the offering including, but not limited to, the additional audit and accounting fees, the legal fees, the cost of an organization and board of directors overhaul to meet listing requirements, marketing fees and underwriter fees.

This paper focuses on start-up firms because firstly, start-ups are usually more reliant on external funding than mature firms. As suggested by Huergo and Jaumandreu (2004) and Darby and Zucker (2003), younger firms usually have more growth opportunity than their older peers; obtaining approval from the CSRC and then going public to achieve external funding are thus more valuable for them. However, due to limited performance records, information asymmetry, and greater uncertainty in bad market conditions, it is harder to evaluate a start-up's value. Previous studies argue that investors often use firm specific characteristics, such as the network of the CEOs, to assess the potential of an IPO firm (Cosh et al., 2009; Field et al., 2013; Yang et al., 2011). With the use of data from China we are able to identify political connections as a specific characteristic as we believe having a member of the ruling party as a member of the firm or having a network of contacts with government officials will reduce firm risk of ideological discrimination, help the firm to tap into key information and therefore to be better prepared for the pre-IPO process (see Li et al., 2008; Chen, 2013).[4]

We use the CEO and other board directors' political connections and percentage of political directors on the board as the proxies for a firm's relationship with government. Referring to Li et al. (2006), we define a politically connected director or CEO as one who satisfies any one of the following three criteria: (1) a current or former member of the National People's Congress (NPC); (2) a current or former member of the Local People's Congress (LPC); and (3) a current or former member of the Chinese People's Political Consultative Conference (CPPCC). The NPC, LPC and CPPCC are influential quasi-governmental organizations in the Chinese political system, the former being the lawmaker and the latter the sole official advisory body. As the appointments of main government officials must be approved by the PC and CPPCC, and such appointments are often influenced by comments from members of the CPPCC, these two organizations have a significant influence on, and a close relationship with, key government officials.[5]

[1] See also Fan et al. (2011), who argue that government plays an extremely important role in China.

[2] A counterpart to the Securities and Exchanges Commission (SEC) in the United States.

[3] This number is calculated by scaling the rejected issues to the total applications. Kutsuna et al. (2009) described that they have incomplete direct information on cancelled offerings but have been advised by industry practitioners that cancellation is rare in Japan. Nomura Securities was able to provide a list of cancellations for the 2001 to 2003 portion of their sample period. During this period, there were 227 completed JASDAQ IPOs. Eleven IPOs were cancelled.

[4] The Communist Party is the single ruling party in China. Literature has argued that having a membership in Communist Party can help firm to reduce the ideological discrimination, to obtain easier accessing in key information as well as valuable resources.

[5] We thank the referee for recommending the use of prior military service or government employment as a proxy. Unfortunately, very few of the CEOs and directors are former army or government officials, hence, we did not take this into account.