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Effects of the shareholder base on firm behavior and firm value in China

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ABSTRACT

Contrary to the evidence based on US firms, we find that a large shareholder base does not benefit firms in China. Our results suggest that a large shareholder base in China implies elevated agency conflicts between individual investors and the controlling shareholders. We find that a larger shareholder base is associated with lower levels of capital expenditures, a lower standard deviation of return on assets, a lower standard deviation of return on equity, and no reduction in dividend payout. Our results imply that insiders increase the expropriation of outsiders as agency conflicts escalate. The shareholder base is associated with a decrease in firm value in China.

1. Introduction

Most companies spend significant time and attention to managing their shareholder base out of the belief that significant stock market benefits can be reaped if they can identify and attract the right shareholders. According to a recent survey by the National Investor Relations Institute (NIRI) and the Rock Center for Corporate Governance at Stanford University, 91 percent of companies discuss shareholder composition at the senior-executive level; 75 percent discuss this at the board level. The survey also finds that CEOs spend 4.2 days per quarter managing their shareholder base and more than three-quarters of firms see significant stock market benefits from managing their shareholder base.¹ Consistent with the opinion of practitioners, many financial economists suggest that the shareholder base is an important determinant of firm value and corporate policies (Lins & Warnock, 2004; Brav, Graham, Harvey, & Michaely, 2005; Bodnaruk & Ostberg, 2013).

Despite the importance of the shareholder base, research on the topic has been scant. The benefits of a large shareholder base, nevertheless, can be inferred from related evidence based on US firms that firm value is enhanced by improvements in investor recognition, stock liquidity, and market disciplines (Merton, 1987; Bodnaruk & Ostberg, 2009; Green & Jame, 2013; Edmans, 2009; Fang, Noe, & Tice, 2009). It is not clear, however, if the benefits of a large shareholder base prevail in developing economies.

Our goal in this study is to determine if the common belief held by business executives that a large shareholder base is beneficial to the firm is true in a foreign setting. In doing so, we examine the effects of the shareholder base on firm behavior and firm value in China. An investigation of the effects of the shareholder base is particularly important for China because there is widespread popular belief that the tremendous stock market growth in China in recent years has attracted sentiment-driven investors mainly. Eun and

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Huang (2007) for instance cite the Wall Street Journal (August 22, 2001) comparing the stock markets of China to “casinos, driven by fast money flows in and out of stocks with little regard for their underlying value.” More recently, the Economist (May 26, 2015) describes China's stock market as a crazy casino. An examination of the shareholder base and its effects in China may provide important insights into firm behavior in this burgeoning economy. In addition, firm ownership structure in China is quite different from the ownership structure in western societies (Tam, 1995, 2000). In China, firms have concentrated ownership and are generally controlled by the state, it is therefore unclear if the benefits associated with the shareholder base can prevail in China.

Several reasons motivate us to examine the shareholder base in China. First, there is some evidence that shareholders in China are eager to protect their interests by monitoring firm behavior. Chen, Ke and Yang (2013) find evidence that after the passage of an investor-friendly regulation in 2004 in China, firms that have a higher level of minority shareholders are more likely to veto value-decreasing proposals while the firm management also submits fewer proposals that may decrease firm value. Accordingly, a larger shareholder base may have some positive impacts on firm behavior and firm value in China. Yet, it is possible that the benefits of a large shareholder base found in developed economies may not prevail in China. Tam (1995, 2000) finds that firms in China remain significantly controlled directly or indirectly by the state despite the market reforms and an increasing number of individual shareholders in recent years. According to Tam (1995), the objective of privatizing firms in China is to install better modus operandi to break away the problems associated with a centrally planned economy while allowing the state to maintain its influence. Recent studies also confirm that the influence of the state on firm behavior is significant in China (Liu, Uchida, & Yang, 2014; Su, Fung, Huang, & Shen, 2014). In addition, Gao and Kling (2012) find evidence that shareholder rights are less relevant in enhancing the quality of financial reporting of firms in China. The results of Tam and Gao and Kling suggest that a larger shareholder base may not have significant benefits in China. Second, China presents an interesting case for examining the shareholder base because before the Shanghai and Shenzhen Stock Exchanges were created in 1991, publicly traded firms and individual investors virtually did not exist. According to the 2013 China Securities Depository and Clearing Statistical Yearbook, the number of A-share stock trading accounts (each investor can only register for one trading account) increased from 58.5 million to 171.9 million between 2000 and 2013 at an annual rate of eight percent; the number of B-share stock trading accounts increased from 0.025 million to 2.51 million over the same period an annual rate of 117.7 percent. The statistics suggest that the shareholder base in China has been growing at a phenomenal rate unseen in other countries and it presents an interesting opportunity for investigating the effect of the shareholder base that arises primarily because investors are enthusiastic about stock ownership. Finally, an investigation of the shareholder base in China may have important policy implications because the country is facing the challenging task of protecting minority shareholders' interests as it develops its domestic financial markets. Given China's poor record of investor protection and weak law enforcement, it is important to determine the role of the shareholder base in its burgeoning capital markets. This is the first study to show how the shareholder base affects the quality of corporate behavior for firms domiciled in weak investor protection countries. It is generally agreed that when firms have concentrated ownership, individual shareholders suffer significant agency costs because the controlling shareholders have incentives to maximize the benefits of control at the expense of small investors (Claessens, 2002; Demsetz, 1983). The extant literature has provided evidence that firms in China suffer significant agency problems due to the presence of state ownership and/or government related controlling shareholders. It would be of interest to know if an expanding shareholder base could promote the monitoring of firm behavior as government-related ownership is diluted. Pagano and Roell (1998) argue that an optimal firm ownership structure generally involves some measure of dispersion, to avoid excessive control by specific shareholders. This hypothesis has not been tested yet in developing countries where firm ownership is concentrated; China provides an interesting platform for investigating the hypothesis.

Using a sample of 20,125 firm-year observations of Chinese companies from 1998 to 2013, we find evidence suggesting that the benefits of the shareholder base found in developed economies do not exist in China. Our results are consistent with the argument that an expanding shareholder base in the presence of concentrated firm ownership is likely to have elevated agency problems (Claessens, 2002; Demsetz, 1983). Specifically, our results show that Chinese firms with a larger shareholder base have lower levels of capital expenditures, a lower standard deviation of return on assets ($\sigma[\text{ROA}]$), and a lower standard deviation of return on equity ($\sigma[\text{ROE}]$). In addition, we find that firms a larger shareholder base are not associated with a reduction in dividend payouts in China. Researchers have concluded that the high dividend payouts of firms in China are expropriations by insiders. Our results on firm risk-taking behavior and dividend payout are thus consistent with the extensive evidence documented in prior studies that corporate resources of firms in China are frequently expropriated to satisfy the private motives of insiders. We also find that the shareholder base is negatively associated with firm value in China. The finding implies that investors are skeptical of the motives of insiders as the conflict between insiders and outsiders escalates.

Our study adds to the scant literature on the shareholder base by examining the effects of the shareholder base on firm behavior and firm value in China. Our results are in general consistent with the existing literature that outsiders are expropriated by insiders of firms in China. Given that China is in the process of developing its capital markets, our findings may have significant policy implications. Our results also add to the literature on investor protection by showing that in countries where investor protection is poor and law enforcement is weak, expanding the shareholder base is unlikely to aid the development of the capital markets as investors are skeptical of the motives of insiders. Our results show that an expanding shareholder base does not improve the monitoring of firms where state ownership is significant and corporate governance is poor. In the case of China, our findings suggest that regulations and governance practices must be improved before the shareholder base can have positive effects on firm policies and firm value.

The rest of the paper is organized as follows. Section 2 reviews the literature and develop testable hypotheses. Section 3 describes the sample and data. Section 4 presents analysis and results. Section 5 concludes the paper.

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