International Review of Economics and Finance 36 (2015) 107–118

Contents lists available at ScienceDirect

International Review of Economics and Finance

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

Private placements, cash dividends and interests transfer: Empirical evidence from Chinese listed firms

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ARTICLE INFO

Available online 13 November 2014

Keywords:
Private placements
Cash dividends
Interests transfer
Large shareholders

ABSTRACT

In this paper, the relationship between private placements of common stocks and cash dividends for Chinese listed firms is investigated. It finds that Chinese listed firms pay more cash dividends after private placements than do those that are not involved in placements. Firms with large shareholders participating in private placements pay more cash dividends than those without large shareholder participation. These results indicate that the firms controlled by large shareholders have a high propensity for interests transfer in their cash dividend policies.

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1. Introduction

As a flexible and elastic way of equity refinancing, private placements have come to serve a function in resource allocation in capital markets. Since the 1990s, private placements have been widely used in public equity markets, such as those in the U.K. and the U.S.

On May 8, 2006, the China Securities Regulatory Commission (CSRC) issued the "Guidance for share issuance", which set out the foundation of private placements. Private placements thus become an official part of equity refinancing in the capital markets in China. Since then, ever-growing numbers of private placements have become one of the most important parts of equity refinancing in China, and are currently used more often than rights offering or public offerings by Chinese listed firms.

Despite the prevalence of private placements, controlling shareholders and actual controllers of Chinese listed firms in private placements are vulnerable to market risk and price fluctuations. Consequently, the controlling shareholders and actual controllers are motivated to seek additional interests to compensate for the market risk and potential losses. A few recent studies have shown that there is interests transfer behavior operating in the issuance process of private placements (Baek, Kang, & Lee, 2006; Cronqvist & Nilsson, 2005). Today, the Chinese stock market is an emerging market, and private placements are in a rapid growth stage in China. Presently, legal regulation, supervision and examination policies are inadequate. Thus, the unique Chinese setting of equity refinancing provides some space for interests transfer for the firms' controlling shareholders through these private placements. The institutional background and high ownership concentration, in particular, also provide an institutional setting in which the issuing objects of private placements are seeking additional benefits to compensate for the associated risk. These factors may lead to more serious interests transfer behavior in Chinese listed firms, in private placements, than in firms in other countries.

"Interests transfer" is defined as controlling shareholders transferring their assets and interests out of an enterprise to pursue private benefits (Johnson, La Porta, Lopez-de-Silanes, & Shleifer, 2000). It expropriates the interests of small shareholders or external

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http://dx.doi.org/10.1016/j.iref.2014.11.011
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investors. Most studies have shown that cash dividends can alleviate the agency problem between large shareholders and small shareholders (Faccio, Lang, & Young, 2001; Klaus & Yurtoglu, 2003). However, because of the special institutional setting in China and the inadequacy of the relevant laws and regulations, controlling shareholders may use cash dividends to expropriate the interests of small shareholders. Indeed, according to prior studies, a cash dividend has been widely used as an interests transfer tool by large shareholders to expropriate the interests of small shareholders in China (Chen, Chen, & Shi, 2003; Chen, Jian, & Wong, 2003; Deng, Zeng, & He, 2007; Lee & Xiao, 2002; Wang, Li, & Lu, 2007; Xiao, 2005; Xu & Liu, 2009; Yuan, 2001).

Generally, Chinese listed firms raise large amounts of funds using equity refinancing to support new projects or expand the business operations. However, this refinancing method has also been used as an important tool by controlling shareholders to pursue their private benefits. Large shareholders then expropriate the interests of small shareholders through cash dividends (Deng, Li, Liao, & Wu, 2013; Liu, Wang, & Wang, 2003; Yu, Chen, & Sun, 2010; Zhang & Xu, 2005).

Prior studies have shown that large shareholders transfer the interests to themselves through high offer price discount rates, long suspension of listings, injection of bad assets, and earnings management (He & Zhu, 2009; Wang, Zhang, & Lin, 2010; Wu, Wei, & Wu, 2010; Zhang & Guo, 2008; Zhang & Guo, 2009; Zhang, 2010; Zhang & Li, 2010). In such cases, the Chinese listed firms immediately pay cash dividends after the placement. By paying the cash dividends, large shareholders can transfer a larger proportion of the available funds out of the firms. On the one hand, this reduces the amount of the funds available to support a new project or expand the scope of operations. Thus, there is a conflict with the general refinancing purpose of such private placements. On the other hand, if Chinese listed firms have sufficient cash to pay a cash dividend, then it raises the question as to why they place shares through private placements to large shareholders in the first place. Indeed, it seems doubtful that the real motivation of the Chinese listed firms in such refinancing lies in raising capital for new projects or expanding the scope of operations. One possible reason is that they transfer interests out of the firms through private placements or improve actual control rights. This process is more beneficial for large shareholders. Via private placements and cash dividend payment meshing with each other after the placement, large shareholders can increase their shareholdings without paying the full market price. Chinese listed firms use extant cash flow to compensate for the risk of their shareholdings. The firms may share in the benefits of placing shares that do not bring real income or appreciation in current asset values. Accordingly, small shareholders' interests decrease. The essence of this behavior can be regarded as an “interests transfer”.

This paper extends previous studies on private placements as follows. First, it provides empirical evidence of the interests transfer problem, caused by cash dividends after a placement, which differs from Zhu, He, and Chen (2008), who illustrate the interests transfer phenomenon of a company using a low offer price along with a high cash dividend payment. Large shareholders transfer the interests, in cash dividends, to their pockets after the placement. Thus, they expropriate the interests of small shareholders. Second, the paper extends the interests transfer topic on private placements to consider dividend policy after a placement. Most prior studies on interests transfer focus on effects before or during the issuance process of private placements, including the mechanism of high offer price discount rate, long suspension of listing, injection of bad assets, and earnings management. Third, results of this study have empirical implications in the refinancing of private placements. Furthermore, it confirms that the refinancing of private placements has become a tool for controlling shareholders to pursue their private benefits and for large shareholders to expropriate the interests of small shareholders using cash dividends after a placement.

The rest of this paper is organized as follows. Section 2 provides a literature review and hypothesis development. Section 3 explains the research design. Section 4 presents the main empirical analysis. The final section provides conclusions.

2. Related literature and hypothesis development

2.1. Related literature

La Porta, Lopez-de-Silanes, and Shleifer (1999) in a ground-breaking study document that ownership is commonly concentrated around the world, excluding the U.K. and the U.S. Although ownership concentration avoids the agency problem between large shareholders and managers under ownership dispersion, in fact, it increases the opportunities for large shareholders to seek private benefits of control. Thus, it actually produces an additional agency problem between large shareholders and small shareholders (Shleifer & Vishny, 1997). Johnson et al. (2000) describe this activity as “interests transfer” or “tunneling”. They suggest that this is a behavior of large shareholders, expropriating the interests of small shareholders. Other studies have explored the interests transfer problem of large shareholders from various perspectives, such as dividend policy (Faccio et al., 2001; La Porta et al., 2000), related transactions (Bae, Kang, & Kim, 2002; Bertrand, Mehta, & Mullainathan, 2002; Cheung, Rau, & Stouraitis, 2006), and debt financing (Aslan & Kumar, 2008; Faccio, Lang, & Young, 2003). Some studies have found that there is an interests transfer problem with large shareholders expropriating the interests of small shareholders in the issuance process of private placements. Cronqvist and Nilsson (2005) investigate the influence of control rights on equity refinancing in Sweden, finding that family controlled enterprises prefer to directionally place shares to family controlled members or to vote shares lower in order to avoid dilution of control rights. Baek et al. (2006) analyze the phenomenon of enterprise groups in Korea conducting interests transfer via private placements. They find that there is an interests transfer problem of controlling shareholders transferring benefits in private placements, with the major issues including diluting the equity of minority shareholders and a higher offer price discount rate for shares to the controlling shareholders.

In China, the stock market has developed along with the reform of state-owned enterprises. The ownership of Chinese listed firms is highly concentrated, so that there is a pattern of large shareholders and small shareholders. Due to the inadequacy of relevant laws on investor protection and weak self-discipline, the agency problem between large shareholders and small shareholders is very

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