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Controlling shareholder, split-share structure reform and cash dividend payments in China ☆

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ABSTRACT

We investigated the relationship between changes in cash dividend payments, non-public tradable shares, and the percentage ownership of the controlling shareholder in Chinese firms before and after the split-share structure reform. We found a significant reduction in cash dividends before and after the reform. Importantly, the reduction in cash dividends is significantly related to the reduction in the largest shareholder's ownership; however, it is not associated with the decline in non-publicly tradable shares. These results suggest that Chinese controlling shareholders' preference for cash dividends is attributable to the inherent illiquidity of their shares rather than non-tradability of shares.

1. Introduction

Numerous perspectives have been proposed to explain corporate dividend payments: agency conflicts between shareholders and managers (e.g., Easterbrook, 1984; Gaver & Gaver, 1993; Jensen, 1986; Zwiebel, 1996); signaling theory (e.g., Asquith & Mullins, 1983; Bhattachaya, 1979; Denis et al., 1994; John and Williams, 1985; Lang & Litzenberger, 1989; Miller and Rock, 1985); life-cycle theory (DeAngelo et al., 2006; Grullon et al., 2002); dividends as a substitute for corporate governance devices (Farinha, 2003; Jensen et al., 1992; Jiraporn & Ning, 2006; John & Knyazeva, 2006; Knyazeva, 2008), and so on. An idea that has recently received a lot of attention from scholars is that especially in countries with concentrated corporate ownership structures (e.g., continental Europe and Asia) controlling shareholders expropriate minority shareholder wealth by exerting influential power on corporate dividend policy (e.g., Easterbrook, 1984; Faccio et al., 2001; Gugler & Yurtoglu, 2003; Jensen, 1986; La Porta et al., 2000; Maury, 2004).[1] The expropriation problem is likely to be evident in countries with weak legal investor protection and, as such, legal systems will also affect corporate dividend payments (Brockman & Unlu, 2009; La Porta et al., 2000).

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[1] Corporate ownership concentration is also evident in the US. Gadhoum et al. (2005) show evidence that 59.7% of US listed firms have a controlling shareholder (a shareholder who owns more than 10% of the firm's shares). They argue that the principal economic consequence of strong shareholder rights in the US is to prevent controlling shareholders from exploiting minority shareholders.

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The expropriation problem is also evident in China because Chinese-listed firms have highly concentrated ownership structures. In addition, China had a unique split-share system in which shares of listed firms were split into two categories: non-publicly tradable shares (NPTS) and publicly tradable shares (PTS) (Huang et al., 2011; Li, Wang, Cheung and Jiang, 2009; Wei & Xiao, 2009; Yeh et al., 2009). The coexistence of the split-share system and the concentrated ownership structure is likely to engender serious expropriation problems (Jiang et al., 2010; Zou et al., 2008). It is likely that analyses on Chinese firms engender further insights on expropriation problems regarding corporate dividend policy.

Importantly, the China Securities Regulatory Commission (CSRC) launched a split-share structure reform program in 2005, with the aim of eliminating NPTS that were a potential source of expropriation problems (China Securities Regulatory Commission, 2005). The ownership structures of Chinese-listed companies changed substantially after the reform; at the end of 2009, approximately 80% of NPTS were converted to tradable shares. Previous studies have suggested that the non-tradability of shares was an important determinant of Chinese controlling shareholders' preferences for cash dividends (Cheng et al., 2009; Huang et al., 2011; Lin et al., 2010; Wei & Xiao, 2009). Accordingly, the substantial reduction in the proportion of NPTS must affect the cash dividend policy.

During the stock reform program, Chinese firms also experienced a decline in ownership concentration that potentially changed their dividend policy. However, to the best of our knowledge, academic studies have paid little attention to the impact of split-share structure reform on Chinese corporate dividend policy. Additionally, the state-launched split-share reform is an exogenous shock for individual firms; therefore, the reduction in NPTS and ownership concentration associated with the reform provides a good opportunity to investigate their effects on cash dividend payments. The current research environment is close to a natural experiment and allows us to avoid endogeneity problems.[2] Therefore, our research took advantage of this and re-examined the relationship between NPTS, ownership concentration, and cash dividend payments in China. In addition, the reduction in ownership concentration via the reform process is relatively small compared to that of NPTS. This fact allowed us to separately investigate the effects of NPTS and concentrated ownership structures on dividend policy.

We computed the differences in cash dividend payments for individual Chinese companies before and after the stock reform and compared this data to the changes in NPTS and the percentage ownership of the largest shareholder. Our empirical evidence indicates that the change in cash dividends is not significantly related to the change in NPTS; however, it is associated with a change in the percentage ownership of the controlling shareholder. Therefore, we argue that inherent illiquidity of stocks of the controlling shareholders is the most important factor as it relates to the controlling shareholder's preference for cash dividends. Previous studies have argued that NPTS has a significant relationship with dividend payouts in China (Cheng et al., 2009; Huang et al., 2011; Lin et al., 2010; Wei & Xiao, 2009). However, our evidence suggests that NPTS, per se, does not affect Chinese corporate dividend policy. A possible interpretation of previous findings is that, before the split-share structure reform, there was an automatic correlation between the proportion of NPTS and percentage ownership of controlling shareholders because the controlling shareholders owned NPTS; as a result, there was a positive correlation between cash dividends and NPTS. Our data also indicated that, after the reform, the percentage ownership by controlling shareholders has had a significant cross-sectional positive relation to the absolute level of cash dividends. In contrast, we did not find any significant associations between the proportion of NPTS over total outstanding shares and the absolute cash dividend level. This result provides further evidence that controlling shareholders still prefer cash dividends because of the inherent illiquidity of their shares.

Our research makes important contributions to the existing literature. Taking China as an example, we present additional evidence that Type II agency problems have a significant explanatory power of corporate cash dividend policy. Our results reinforce the idea that in China cash dividends exacerbate expropriation problems between controlling and minority shareholders (Cheng et al., 2009; Huang et al., 2011; Lee & Xiao, 2004; Lin et al., 2010; Lv & Zhou, 2005; Tang & Luo, 2006; Wei & Xiao, 2009; Yuan, 2001). Previous studies have argued that stock non-tradability engenders agency problems regarding dividend policy between controlling and minority shareholders (Cheng et al., 2009; Huang et al., 2011; Lee & Xiao, 2004; Lin et al., 2010; Lv & Zhou, 2005; Tang & Luo, 2006; Wei & Xiao, 2009; Yuan, 2001). To the best of our knowledge, this is the first paper to demonstrate that ownership concentration is more relevant to corporate dividend policy than non-tradability of shares. Specifically, as long as controlling shareholders desire to keep control rights, their shares will be less liquid, and controlling shareholders will prefer cash dividends. Importantly, we present evidence in a research environment that does not suffer from endogeneity problems to the extent that previous studies have.

The remainder of this paper is organized as follows. In Section 2, we present a literature review and background information. Section 3 presents hypotheses as well as a simple model of agency problems and dividend payments. Section 4 presents the sample selection procedure and data. In Section 5, we present the empirical results. Section 6 discusses further analyses. Section 7 discusses alternative explanations of our empirical results. Section 8 summarizes and concludes the current research.

2. Previous studies and background information

Numerous studies have been devoted to establishing the reasons why firms pay dividends. A well-cited idea is that dividend payments mitigate agency conflicts between shareholders and managers (Type I agency problem) (Easterbrook, 1984; Jensen, 1986; Jensen & Meckling, 1976; Zwiebel, 1996). Dividend payouts create shareholder value by reducing free cash flow that will be spent in value-decreasing projects by empire-building managers (Chae et al., 2009; Lang & Litzenberger, 1989). The role of

[2] For example, firms that pay high dividends are likely to maintain a high proportion of NPTS held by the controlling shareholders.