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Political considerations in the decision of Chinese SOEs to list in Hong Kong[☆,☆☆]

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ABSTRACT

This paper investigates why Chinese state-owned enterprises (SOEs) with strong political connections (i.e., politically connected firms) are more likely to list overseas than non-politically connected firms. We find that connected firms' post-overseas listing performance is worse than that of non-connected firms. This evidence suggests that connected firms' managers list their firms overseas for private (political) benefits. Consistent with this private benefits explanation, we further find that connected firms' managers are more likely to receive political media coverage or a promotion to a senior government position subsequent to overseas listing than domestic listing.

1. Introduction

The sale of state-owned enterprises (SOEs) by a government, commonly known as "privatization," has become a widespread global phenomenon in recent decades.[1] Many emerging economies are privatizing SOEs through listing in developed markets overseas. However, while prior literature suggests that political relations and the nature of institutions affect privatization outcomes (Megginson and Netter, 2001; Gupta, 2005; Fan et al., 2007), it is silent on the role of political

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[1] We use the terms state-controlled enterprises and state-owned enterprises interchangeably. Both refer to partially privatized government-owned firms (i.e., listed firms in which the government retains control rights).

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connections in SOEs' decisions about overseas listing. We shed light on this issue using evidence from China, which has launched a privatization program of unprecedented magnitude in global financial markets.

To analyze the role of political connections in the overseas listing of Chinese SOEs, we begin by assembling data on Chinese SOEs listed on worldwide (domestic and overseas) stock exchanges from 1992 to 2005. We find that among our sample of 1,018 firms, 939 are listed only on domestic stock exchanges (Shenzhen and Shanghai stock exchanges). The remaining 79 firms exhibit little variation in their overseas listing destinations—78 are listed in Hong Kong, 14 in New York, and 5 in London, where consistent with the China Securities Regulatory Commission (CSRC) Hong Kong listings are treated as overseas listings because Hong Kong is a separate jurisdiction from the People's Republic of China (PRC). Thus, while markets such as the U.S. attract some SOEs seeking to tap into the largest pool of foreign capital, Hong Kong is the primary destination of Chinese SOEs' overseas listings. We further find that 43% of our sample SOEs are politically connected, that is, have a Chairman or CEO that is a current or former government bureaucrat, and that politically connected firms are more likely to list overseas than non-politically connected firms.

We next explore why politically connected SOEs are more likely to list overseas than non-politically connected SOEs. We propose two non-mutually exclusive hypotheses for this relation. First, the *performance hypothesis* posits that politically connected firms exhibit better performance than non-politically connected firms subsequent to overseas listing. The rationale is that politically connected firms can derive significant benefits, such as government subsidies or state loans, from their political ties. Second, the *private benefits hypothesis* posits that managers of politically connected firms use overseas listing to realize private political benefits. Due to strong government intervention in the corporate sector in China, an executive position in a large Chinese SOE often leads to a promotion to a senior government position. Overseas listing can therefore provide managers of connected firms a new channel to realize political rents.

The results of our hypothesis tests support the private benefits hypothesis but not the performance hypothesis. Specifically, we find that among politically connected firms, managers of overseas listed firms are more likely to receive recognition in the political media or a promotion to a senior government position than managers of domestically listed firms. In contrast, post-overseas listing performance is lower for politically connected firms than for non-politically connected firms.

In additional analyses we find that the average sales growth during the pre-overseas listing period is significantly lower for politically connected firms than for non-politically connected firms, which supports our main conclusion. Further, we examine whether earnings management accounts for our post-listing performance result. We find no significant difference in our earnings management proxy between politically connected and non-politically connected firms. Thus, the weaker post-listing performance of politically connected firms is not due to greater earnings management in these firms.

Our study contributes to the literature in several ways. First, our paper extends Fan et al. (2007), who find that Chinese firms with political connections underperform those without political connections subsequent to IPO, by documenting that connected firms are more likely to receive recognition in the political media or a promotion to a senior government position. This finding also adds to our understanding on the managerial labor market in China by showing that SOE managers' political career concerns can drive a wedge between the interests of SOEs' managers and minority shareholders.

Second, our finding that firms with strong political connections are more likely to list overseas differs from Leuz and Oberholzer-Gee (2006), who show that Indonesian firms that have strong ties with the Suharto family are less likely to list overseas. This difference is likely due in part to the fact that in our setting, overseas listing can help managers increase their political recognition and advance their political careers. Further, while politically connected firms listed overseas can face embarrassing outcomes such as delisting if they continually underperform, this issue is less likely a concern for politically connected managers who are motivated by private political benefits from pursuing social or political objectives. In addition, unlike Indonesian firms, Chinese SOEs are likely to receive support from the government and parent companies if facing a threat of delisting (Jian and Wong, 2010).

Our finding that managers of politically connected Chinese SOEs can extract private benefits from listing overseas may seem to contradict the literature that finds overseas listing in mature markets generally improves corporate governance (e.g., Coffee, 2002; Leuz and Oberholzer-Gee, 2006). An important explanation for the different results is that the main overseas listing market for our sample is Hong Kong, while prior studies generally focus on U.S. listings. Although Hong Kong has high-quality governance institutions that can lead to bonding effects for non-connected firms, its political dependence on China can also enable politically connected managers of Chinese SOEs to extract private benefits upon listing there.

Finally, our paper reconciles mixed findings in prior research on the impact of stock markets on partially privatized SOEs. In particular, while Gupta (2005) suggests that stock markets play an important monitoring role that facilitates performance improvement in partially privatized firms in India, Fan et al. (2007) document that this finding does not generalize to partially privatized Chinese firms listed on domestic stock exchanges. By comparing the performance of non-politically connected Chinese SOEs listed overseas and domestically, we provide evidence that the effect of partial privatization depends on the institutional environment, with more informative stock markets (i.e., overseas stock markets, as opposed to domestic Chinese stock markets) having more of a monitoring effect when the government remains the controlling owner.

The remainder of the paper is structured as follows. Section 2 describes the institutional setting and hypotheses. Section 3 presents the data and descriptive evidence on the positive relation between political connections and overseas listing. Section 4 reports the empirical results. Section 5 presents additional analyses and Section 6 summarizes the study and concludes.