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Block trade targets in China

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ABSTRACT

We examine characteristics associated with the probability of Chinese companies being block trade targets. We find that the proportion of non-publicly tradable shares over total outstanding shares is positively related to the probability of firms being block trade targets before the split-share structure reform. Ownership concentration, director ownership, and firm size were negatively related to the frequency of firms being block trade targets during the pre-reform period. Pre-reform firms with high free cash flow were likely to be block trade targets, and bidders paid a high premium to acquire those companies. The cost of a block trade increased significantly after the split-share structure reform, and the frequency of block trades declined considerably. These results suggest that before the reform Chinese bidders mainly pursued private benefits of control rather than capital gains from value-increasing takeovers. After the reform, bidders have bought tradable shares and paid a negative premium, suggesting that being a blockholder in Chinese companies implies costs that exceed benefits.

1. Introduction

An important function of stock markets is to provide investors with an opportunity to obtain control rights of a company; as such, they are markets for corporate control. It is well documented that bidders take over poorly managed companies that suffer from low stock prices and enjoy capital gains by improving the management. Developed countries such as the US and the UK have active takeover markets. Numerous studies, including those by Bliss and Rosen (2001), Brav et al. (2008), Duggal and Millar (1999), Masulis et al. (2007), etc., have investigated various issues regarding acquisitions (e.g., characteristics of acquirers and target companies, stock price reactions to takeover announcements, performance and financial policy changes following takeovers). Transactions for corporate control are also conducted in emerging markets that typically have weak legal protection of investors. In those countries, ownership structures are highly concentrated and, as a result, controlling shareholders pursue large private benefits of control (PBC) minority shareholders do not share (Dyck and Zingales, 2004; La Porta et al., 1999, 2000a). Indeed, previous studies show evidence that insiders enjoy large private benefits in emerging markets (Claessens et al., 2000; Dyck and Zingales, 2004; Johnson et al., 2000; La Porta et al., 2000a, 2000b). These facts naturally raise an important question: do bidders in emerging markets mainly pursue PBC, or do they seek capital gains by implementing value-increasing takeovers?

To answer the question this paper investigates which companies are more likely to be block trade targets in emerging markets. To the best of our knowledge, scant research has addressed the issue as it relates to emerging markets, although such analyses will help us understand the motives behind the transactions.[1] We use Chinese data to address this issue because typical Chinese

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[1] Previous studies have investigated the level and determinants of PBC for Chinese companies (Deng and Zeng, 2004; Tang and Jiang, 2002; Yang and Wang, 2008; Ye, 2003; Yu et al., 2006) using block trade data. However, most studies pay attention to the level and determinants of PBC (block premium); limited analyses exist on firm characteristics associated with the probability of firms being block trade targets.

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companies have highly concentrated ownership structures (Peng et al., 2011). In addition, Chinese firms have adopted segmented share structures, in which firms issue non-publicly tradable shares (NPTSs) as well as publicly tradable shares (PTSs). NPTS holders are not allowed selling their shares in the secondary market and thus have only limited opportunities to realize capital gains. A segmented share structure, combined with a concentrated ownership structure, is likely to give Chinese controlling shareholders only weak incentives for value maximization, which in turn generates severe expropriation problems (Chen et al., 2009; Firth et al., 2006; Gul et al., 2010; Jiang et al., 2010; Wang, 2005; Wei and Xiao, 2009; Zou et al., 2008).[2] Fan et al. (2011) stress that government quality and state ownership influence the governance of firms in emerging markets. China is typical of countries in which government exerts strong power over many listed companies. As a result, Chinese companies are likely to pursue public objectives rather than value maximization for minority shareholders.[3] Meanwhile, block trades for corporate control rights are relatively active in the Chinese stock market. According to the China Center for Economic Research (CCER) Mergers and Acquisitions database, there were 1561 M&A deals involving 675 companies between 2003 and 2009.

It is noteworthy that in 2005, the China Securities Regulatory Commission (CSRC) required firms to initiate split-share structure reform that converts NPTSs into PTSs. As a result, block trades in China showed a notable change during the mid-2000s. PTSs are exclusively transferred in block trades following the split-share structure reform, while NPTSs were mainly transferred before the reform. Chinese bidders before the split-share structure reform had only limited opportunities to realize capital gains, and thus may have found it difficult to receive sufficient returns from value-increasing takeovers. In contrast, bidders after the reform have considerably increased opportunities to realize capital gains and thereby increase incentives to maximize value. The split-share structure reform allows us to analyze whether share non-tradability affects bidders' objectives and the characteristics of target companies.

Our entire sample consists of 9095 firm-year observations involving 1612 companies listed on the Shanghai and Shenzhen stock exchanges between 2003 and 2009. Before the split-share structure reform, the proportion of NPTSs over all outstanding shares was positively associated with the likelihood that a firm would become a block trade target. We also find that firms with less concentrated ownership structures and low director ownership were more likely to be block trade targets before the reform. Pre-reform bidders were likely to target small firms with large free cash flow. On the other hand, we do not find evidence that poorly performing firms were more likely to be block trade targets before the reform. These results suggest that pre-reform bidders mainly pursue private benefits rather than capital gains from value-increasing takeovers. Accordingly, we find that only about 0.6% of firm-years that completed the split-share structure reform (and thereby substantially decreased NPTSs) experienced block trades (as a target); whereas, about 5% of firm-years that had not yet completed the reform became block trade targets.

It is important to examine block premium to investigate whether Chinese bidders pursue private benefits and why the frequency of block trades declined considerably after the split-share structure reform. When we compute the block premium by using the book value of net assets (block trade price minus book value of net assets per share, divided by book value of net assets) for pre- and post-reform trades, the block premium shows a statistically and economically significant increase before and after the split-share structure reform. Specifically, the mean (median) premium increased from 40.4% (10.6%) for the pre-reform period to 190% (109.9%) for the post-reform period. This result indicates that the existence of NPTS provided Chinese bidders with low cost opportunities to obtain control rights of a company to extract private benefits. We also find that block premium before the reform is positively related to free cash flow. This result suggests that firms with large free cash flow provide bidders with large private benefits of control, and therefore are likely to be block trade targets. In contrast, we do not find evidence that controlling shareholders of well-performing companies receive sufficient returns by selling their NPTSs in block trades.

This paper makes substantial contributions to the literature by showing that bidders mainly pursued private benefits in China before the split-share structure reform (existence of non-publicly tradable shares). Our results also include important policy implications on the split-share structure reform. The decreased block trades suggest that the reform makes it difficult to engage in control rights transactions for extracting private benefits. In addition, we find that post-reform bidders tend to pay lower than the market price to obtain publicly tradable shares. This finding suggests that the split-share structure reform successfully curbs controlling shareholders' ability to extract private benefits of control.

The remainder of this paper is organized as follows: Section 2 presents the hypothesis development; Section 3 shows the sample selection procedures and variables; in Section 4, we present the empirical results; Section 5 discusses further analyses; and finally, we provide concluding remarks in Section 6.

2. Hypothesis development

We investigate whether Chinese investors engage in block trades to pursue PBC extraction or value maximization (the PBC extraction view versus the value maximization view). This section presents testable hypotheses upon these views. We should bear in mind that some of the following hypotheses can be derived from both views.

[2] PTS and NPTS holders have the same voting rights (one share one vote). However, NPTSs cannot be sold on the secondary market and NPTS holders neither achieve capital gains in the secondary market nor bear losses from stock price reductions. NPTSs exist to let their holders keep control on firms. In fact, the majority of controlling shareholders in China hold NPTSs, and NPTS holders have stronger control power on the firm than PTS holders.

[3] Chen et al. (2011) argue that government intervention through state ownership or the appointment of connected directors distorts firms' investment behavior and harms investment efficiency.