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Does CEO turnover matter in China? Evidence from the stock market

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ABSTRACT

We study the consequences of CEO turnover announcements on the stock prices of firms in China, where most listed firms remain majority-owned by the state. Our proposition is that state ownership may affect stock market reaction to CEO replacement because state-owned firms often pursue multiple, potentially contradictory, objectives, i.e. economic performance and social objectives. Applying standard event study methodology to a sample of 1155 announcements from 2002 to 2010, we find that CEO turnover typically produces a positive stock market reaction. The reaction is significantly positive, however, only for enterprises owned by the central government, and not significant for enterprises owned by local governments or privately owned enterprises. These results suggest that a CEO turnover in a central state-owned enterprise signals a renewed commitment to the economic performance objective by state officials. The small size of CEO labor market suggests that other shareholders have a relatively small pool of CEO talent to proceed to managerial improvement when a CEO turnover takes place.

1. Introduction

This paper considers the reaction of the Chinese stock market to announcements of a change in the chief executive officer (CEO) of a listed firm. The concern for stockholders is whether CEO

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replacement will influence the company's stock value. Market expectations provide clues about the effectiveness of one of the most important internal monitoring mechanism: the possibility to dismiss a poor performing CEO, which allows evaluating the maturity of corporate governance in China.

Most firms listed on China's stock exchanges are still majority-owned by the state. In Chinese state-owned firms, the board of directors typically rubber-stamps the decision by state authorities to replace the CEO (Kato & Long, 2006). The incoming manager is thus expected to act in line with the state controlling shareholder objectives. By implication, the impact of CEO turnover is likely to be different for a state-owned enterprise and a privately held enterprise to the extent the objectives of controlling shareholders diverge.

Does CEO turnover actually affect stock prices? While the immediate intuition is that CEO turnover should influence stock prices, the theoretical literature offers three distinct views on this issue.

The *scapegoat hypothesis* predicts no abnormal change in stock returns around CEO turnover announcements. Here, the market assumes CEOs are fungible. Dismissal in case of poor performance is only required as a threat to insure that CEOs exert efforts. The next manager is not expected to have a higher ability. The *information hypothesis*, in contrast, predicts negative abnormal stock returns around the time of the CEO turnover announcement as it reveals information about poor management choices. The *ability hypothesis* considers that abilities of CEOs vary, so boards seek out the best talent available. Thus, there should be a positive stock market reaction as the market expects the succeeding CEO to be a better manager.

The empirical literature attempting to disentangle these assumptions fails to provide clear conclusions about stock market reactions to such events. Some studies find a positive reaction (Adams & Mansi, 2009), others a negative reaction (Dedman & Lin, 2002), or no significant reaction (Warner, Watts, & Wruck, 1988). All studies in this area deal with the stock market of developed countries. Our paper is thus the first to our best knowledge to investigate this issue in a developing country.

The existing literature shows that the probability of a CEO turnover in China increases when a firm performs poorly. Kato and Long (2006) point out the connection between CEO replacement and firm performance is generally more tenuous for state-owned enterprises, which, they postulate, tend to pursue mutually conflicting objectives. They might act in order to correct market failures by pursuing social goals such as high employment (Dixit, 1997). They might seek their own private benefits by tunneling resources from their listed subsidiary, as pointed out in China by Jiang, Lee, and Yue (2010). All these objectives come at the expense of economic performance. State-shareholders need, however, to maintain a minimum level of performance in order to pursue their multiple objectives. Indeed, Chang and Wong (2009) find that the link between CEO turnover and firm performance only exists in loss-making state-owned enterprises. If state-owned enterprises incur too many losses, state-shareholders face a high incentive to restore economic performance in order to pursue their multiples objectives in the future. Thus, CEO turnover in a state-owned enterprise may signal a recommitment on the part of the state shareholder to improve the firm's economic performance. We, thus, expect a positive market reaction to CEO turnover in a state-owned enterprise.

While the pool of available CEOs in China is increasing rapidly, there appears to be an insufficient supply on the CEO labor market (Fan, Lau, & Young, 2007). Party membership can be interpreted as an indicator of human capital for managers (Li, Meng, Wang, & Zhou, 2008). We expect central state-owned firms to be more able to attract managers with the highest party responsibilities. We therefore expect a greater positive market reaction when a CEO turnover announcement involves an enterprise owned mainly by the central government; CEOs of such state-owned enterprises are likely to be high-level party members themselves or have close ties with the party elite.

To assess the impact of CEO turnover announcements on stock prices, we apply standard event study methodology to a sample of 1094 CEO turnover announcements from 2002 to 2010. Our overall finding is that market reactions to CEO turnover announcements are positive. Consistent with the hypothesis that these central state-owned enterprises have far greater opportunities to recruit the top CEO talent, we find this positive market reaction applies only to the sub-sample of central state-owned enterprises. Thus, the ability hypothesis applies to central state-owned enterprises in China, while the scapegoat hypothesis applies to privately owned enterprises and enterprises owned by local administrations.