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Tunneling, propping, and expropriation: evidence from connected party transactions in Hong Kong☆

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Abstract

We examine a sample of connected transactions between Hong Kong listed companies and their controlling shareholders. We address three questions: What types of connected transactions lead to expropriation of minority shareholders? Which firms are more likely to expropriate? Does the market anticipate the expropriation by firms? On average, firms announcing connected transactions earn significant negative excess returns, significantly lower than firms announcing similar arm's length transactions. We find limited evidence that firms undertaking connected transactions trade at discounted valuations prior to the expropriation, suggesting that investors cannot predict expropriation and revalue firms only when expropriation does occur.

JEL classification: G15; G34; K33

Keywords: International corporate governance; Legal systems; Expropriation; Connected transactions; Pyramids; Tunneling; Propping

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The July 8, 2000 edition of the South China Morning Post reported: Last December, DCI agreed to pay HK$130 million to a private company of its chairman, Dickson Poon, for services linked to setting up its new cyber mall and shopping centre in Kowloon. … It also agreed to buy HK $100 million worth of start-up equipment from suppliers chosen by Mr. Poon's Dickson Management Consultancy. … This transaction was the latest of many between Mr. Poon's public and private companies that raised eyebrows. … What is so glaring about this case is the large payment for services that the chairman's private firm would seem to have no particular expertise in.

1. Introduction

In companies with concentrated ownership, controlling shareholders can expropriate wealth from minority shareholders in many ways. For example, they can extract cash by selling assets, goods, or services to the company through self-dealing transactions; they can obtain loans on preferential terms; they can transfer assets from the listed company to other companies under their control; and they can dilute the interests of minority shareholders by acquiring additional shares at a preferential price (Johnson, La Porta, Lopez-de-Silanes, and Shleifer, 2000).

However, despite considerable anecdotal evidence, little direct systematic evidence is available on the specific transactions through which expropriation occurs. Most of the academic literature has attempted to measure expropriation indirectly (see, for example, Bertrand, Mehta, and Mullainathan, 2002; La Porta, Lopez-de-Silanes, Shleifer, and Vishny, (LLSV), 2000a, 2002; Claessens, Djankov, Fan, and Lang, 2002; Faccio, Lang, and Young, 2001). Moreover, the literature offers mixed evidence that minority shareholdings lose value as a result of specific expropriation actions (see, for example, Bae, Kang, and Kim, 2002; and Buysschaert, Deloof, and Jegers, 2004).

In contrast to earlier studies, we directly examine all transactions between publicly listed firms in Hong Kong and their controlling shareholders and directors, where expropriation might be likely to occur, and show their incidence and valuation effects. We derive our data from a sample of 375 filings of connected transactions, worth a combined HK$123 billion (US$16 billion), by companies listed on the Stock Exchange of Hong Kong during 1998–2000. In addition, we compile a comprehensive database of financial, ownership structure, and corporate governance data for 609 publicly listed Hong Kong firms, allowing us to compare the firms undertaking these types of transactions with firms that do not.

Our data enable us to describe in detail the mechanisms through which controlling shareholders might expropriate minority shareholders and to substantiate the occurrence of real tunneling in the Hong Kong market. We attempt to answer three questions: (1) What types of connected transactions are likely to lead to expropriation of minority shareholders? (2) What are the characteristics of firms more likely to expropriate? (3) Does the market anticipate the expropriation by firms? Questions (1) and (3) are not independent. Prior research has suggested that firms that are ex ante more likely to expropriate minority shareholders trade at discounted valuations (Claessens, Djankov, Fan, and Lang, 2002; Lemmon and Lins, 2003). Consequently, investors arguably could be protected from the expropriation by purchasing their shares at a discount (Fan and Wong,