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Political connections and the long-term stock performance of Chinese IPOs☆

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ABSTRACT

We analyse the long-term stock performance of Chinese initial public offerings (IPOs) between the years of 2000 and 2007. The results reveal that firms with political connections experience better long-term stock performance. Our results suggest that the abolition of the Issuance Quota System and Channel Restriction System has a negative influence on the long-term performance of IPOs. This evidence is consistent with the view that local government officials are likely to select politically connected companies to go public.

1. Introduction

United States (US) studies have presented evidence that the stocks of firms that go public significantly underperform those of their matched peers (Loughran and Ritter, 1995; Ritter, 1991; Ang et al.,

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2007). Long-term underperformance has also been observed in many non-US countries like Egypt, Japan, Korea, Spain, Switzerland, Sweden, UK, and so on (Aggarwal et al., 1993; Álvarez and González, 2001; Aussenegg, 2000; Cai and Wei, 1997; Keloharju, 1993; Kim et al., 1995; Levis, 1993; Omran, 2005; Page and Reyneke, 1997; Drobetz et al., 2005). The existence of long-term underperformance still remains a puzzle in the finance field, even though numerous works have been devoted to this issue (Brav and Gompers, 1997; Teoh et al., 1998; Kahle, 2000; Schultz, 2003; Guo et al., 2006).

Many studies have investigated Chinese IPOs that have some unique characteristics (Chan et al., 2004; Huang and Song, 2005; Mok and Hui, 1998; Yu and Tse, 2006; Wang, 2005), but few addressed the long-term stock underperformance of Chinese IPOs. As an exception, Chan et al. (2004) documented that A-share IPOs only experience a limited amount of underperformance, with the wealth relatives ranging from 0.90 to 0.98 (wealth relatives with a value lower than one means that IPO firms underperform their matched companies)[1]. This result suggests that Chinese IPO firms experience less long-term stock underperformance. A more detailed analysis of Chinese IPOs will enable us to determine the key factors associated with long-term stock underperformance during post-IPO periods.

Previous Chinese IPO studies suggest that political connections significantly influence the process of going public (Fan et al., 2007; Francis et al., 2009). Fan et al. (2007) show that politically connected IPO firms in China are not conducive to maximizing shareholders' value and are associated with poor post-IPO performance. Although government intervention may reduce the efficiency of politically connected firms, political connections are likely to provide preferential benefits to those firms and alleviate investor fears of bankruptcy (Faccio et al., 2006; Faccio, 2006; Francis et al., 2009). Francis et al. (2009) found evidence that Chinese IPO firms with political connections received significant preferential benefits in the form of a relatively higher offering price, lower underpricing, and lower fixed costs.

This study primarily investigates whether political connections affect the long-term stock performance of the IPO firms by applying Chinese data. The Chinese IPO market has experienced significant institutional changes during the past decade. Until 2004, local government officials exerted strong control over selections of companies to go public under the Issuance Quota System and Channel Restrictions System. These regulations were removed in 2005, when the book-building system was introduced. As such, we believe that Chinese data will provide a rich research opportunity regarding the relationship between political connections and IPO firms' performance.

We find a positive and significant relationship between adjusted buy-and-hold returns and political connections by analyzing a sample of 627 IPO firms that went public between the years of 2000 and 2007. The calendar time portfolio regressions also illustrate that portfolios composed of politically connected IPO firms suffer less from long-term underperformance when compared with portfolios of firms without political connections. In addition, given the large number of state-owned enterprises (SOEs) with political connections that went public during 2000–2004, our results suggest that IPOs under the Issuance Quota System and Channel Restrictions System experienced a better long-term stock performance than IPOs after the introduction of the book-building system. Overall, the results suggest that political connections create value for Chinese IPO companies.

The remainder of this paper is organised as follows. Section 2 presents the background information and the hypotheses. Section 3 explains the methodology. Section 4 details the sample selection procedures and long-term stock performance of the sample firms. Section 5 presents the empirical results. Finally, Section 6 is a brief summary of the paper.

2. Background information and hypotheses

Over the past 30 years, a series of economic reforms has been introduced in China, which has enhanced their transition from a centrally planned economy towards a market-oriented economy. A key aspect of the economic reform process was the Chinese Government's establishment of the

[1] Chan et al. (2004) also found that B-share IPOs outperform all benchmarks, with the wealth relatives ranging from 1.105 to 1.453.