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Blockholding and market reactions to equity offerings in China☆

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ABSTRACT

We examine the impact of blockholding on shareholders' wealth in equity offerings in China. We find that investors generally react negatively to equity-offering announcements by firms with high blockholding. A one-standard-deviation (12%) increase in blockholding leads to a 0.59% reduction in firm valuation over a seven-day window and a 5.50% reduction over a 2-year period surrounding the announcement. Private (non-governmental) blockholding is associated with a more negative valuation effect than governmental blockholding over the long-term event window. The above result holds only for financially constrained firms but not unconstrained firms. Further analysis shows that firms with private blockholding have greater positive cash–cash flow sensitivity than firms with governmental blockholding, and again, the result holds for financial constrained firms only. Collectively, the findings suggest that equity offerings in China signal the issuers' future financial constraints, but the findings do not support the agency hypothesis of state ownership.

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1. Introduction

This study relates the wealth effect of equity-offering announcements in China to the issuers' ownership structure and provides new explanations for the findings. Listed firms in China are characterized by their unique ownership structure and are significantly influenced by government in terms of ownership and policies. During our sample period, the cross-sectional average of the non-tradable ownership is above 60%.[3] Although most non-tradable shares are still directly or indirectly owned by the central government or local governments, some of them have been sold or transferred to private investors over time. The special ownership structure should affect investors' perceptions regarding managers' incentives to deal with the proceeds efficiently, which will be reflected in market reactions to the news.

Using 406 equity-offering announcements by seasoned firms in China from May 2000 to December 2004, our analysis starts with a general test for a relationship between valuation change around equity-offering announcement and blockholding, which is defined as the sum of state ownership and legal-person ownership. We find a negative relationship between valuation change and blockholding, after controlling for firm characteristics, type of offering, and corporate-governance variables. In economic terms, a one-standard-deviation increase in blockholding (12%) leads to a 0.59% reduction in firm valuation over a seven-day window and a 5.50% reduction over a 2-year period surrounding the announcement.

The negative relationship between market reaction to equity announcement and blockholding is consistent with two hypotheses we propose in the following: the agency hypothesis and the financial constraint hypothesis.[4] The two hypotheses have different empirical predictions about the impacts of different types of blockholding, however, as summarized below.

The agency hypothesis follows from early theoretical studies indicating that government ownership is detrimental to minority shareholders.[5] The following empirical studies for China also show that tunneling is prevalent in listed state-owned enterprises (SOEs) (Cheung et al., 2009) and that a CEO's political connection is associated with poor post-IPO performance (Fan et al., 2007).[6] Several recent incidents and studies, however, also point out the problems of private enterprises in China. For example, over the past few years, more than 300 small Chinese enterprises have gotten listed in the United States by reverse mergers, but many of them lag behind in the market and are accused of poor management.[7] Empirically, Chen et al. (2009a) show that listed firms with private blockholders who are not affiliated with government perform worse than other listed firms, and Sun and Wang (2011) also find that excess cash is valued less in listed firms with private blockholders. In sum, the agency hypothesis is mixed about whether governmental or private blockholding is associated with a more negative market reaction to equity offering in China.

The financial constraint hypothesis predicts that an equity offering is a bad signal about the issuer's financial health. This hypothesis follows from Daniel and Titman's (1995) argument that an equity offering

[3] In general, each listed state-owned enterprise has five categories of shares. Three of these five categories, namely state shares, legal-person shares, and employee shares, are non-tradable. State shares are owned by governments at different levels, governmental agencies, or solely government-owned enterprises. Legal-person shares are owned by domestic institutions, most of which are partially owned by governments at different levels. Therefore, state owners and legal persons are similar, except that most legal persons helped in starting up the listed companies they own, and they often have close business connections to those listed companies (Sun and Tong, 2003). The remaining two types, domestic shares and foreign shares, are tradable. In 2005, the Chinese government launched a share-structure reform that ultimately converts all non-tradable state and legal-person shares to be tradable. Although many firms have gone through the restructuring, few shares have been sold to the market.

[4] Market timing is another well-documented motivation for equity offerings in the United States, but there is no theoretical reason to suggest why the ability to time the market increases in blockholding. Besides, market timing is more difficult in China than in the United States because firms in China usually takes several months to a year to go through all the approval processes before issuing shares, as described in Section 2.

[5] Shleifer and Vishny (1994) theoretically show that political controls over firms reduce efficiency, as politicians are more concerned with their political interests than profitability. Claessens and Fan (2002) argue that government officials in China have weak incentives to monitor managers of listed companies, because they are only agents of the owners (the citizens), and not the ultimate owners.

[6] Strictly speaking, the term "SOE" refers to an enterprise that is completely owned and controlled by government. Many studies on the Chinese capital market, however, also use "SOE" for firms that are partially privatized through initial public offerings. To avoid confusion, we use "listed SOE" for partially privatized SOEs to distinguish them from other SOEs that are solely government-owned. We further classify listed SOEs into listed central SOEs and listed local SOEs, according to the identity of the largest shareholder.

[7] "Beware this Chinese Export" (August 28, 2010), *Barron's Online*.

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