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The stock market reaction to the 2005 split share structure reform in China[☆]

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ABSTRACT

During 2005–2006, the Chinese government implemented the split share structure reform, aimed at eliminating non-tradable shares (NTS), i.e. the shares typically held by the State or by politically connected institutional investors that were issued at the early stage of financial market development. Our analysis, based on the time series of risk factors and on the cross-section of abnormal returns, confirms that the split share structure reform was particularly beneficial for small stocks, stocks characterized by historically poor returns, stocks issued by companies with low transparency and weak governance, and for less liquid stocks. Historically neglected stocks also witnessed an increase in the volume of trading and market prices. We conclude that the reform laid down the conditions for important future changes in ownership, liquidity and corporate governance in China.

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1. Introduction

Ever since the late 1980s the Chinese corporate sector was overwhelmingly dominated by State-Owned Enterprises (SOEs). Significant steps were taken with the establishment of two major stock exchanges in 1990 and 1991 and with the first wave of capital-raising IPOs, which initially diluted government ownership of the typical Chinese firms. Yet controls remained firmly in State hands, largely due to the peculiar structure of listed firms. At the beginning of 2005, about two thirds of the Chinese stock market was composed of non-tradable shares (NTS), a special class of shares entitling the holders to the same rights as holders of ordinary shares except for public trading. Typically, these shares belonged to the State or to domestic financial institutions ultimately owned by central or local governments.¹ There was an implicit contract between investors and the State that NTS would never be traded in the stock market. As we will document in this paper, companies characterized by a high proportion of NTS were typically neglected by investors.

In 2005, the Chinese authorities announced a reform aimed at eliminating NTS by the end of 2006 (the split share structure reform, henceforth “the reform”). The reform obliged the holders of NTS to compensate the holders of tradable shares (TS) for the possibility to sell their shares in the future. Apart from the compensation, the reform had very little *direct immediate* impact on the structure of the Chinese stock market in the short run. However, it can be regarded as value-enhancing for several reasons. First, stocks should benefit from the expectation of a more diffuse ownership structure.² Second, the reform sets the stage for an advancement of the privatization process and corporate governance improvements which in turn should enhance the value of the firm (see Stulz (2005), Doidge et al. (2007), Gompers et al. (2003), Bebchuk and Cohen (2005), Cremers and Nair (2005), Bebchuk et al. (2009) and Morey et al. (2009)).³ Third, the increase in the supply of TS should have a positive effect on liquidity (see Amihud (2002), Pastor and Stambaugh (2003) and Acharya and Pedersen (2005)).⁴ Finally, the resolution of uncertainty, created by previous failed attempts to reform the Chinese stock market, should be positive due to its elimination of a source of non-diversifiable risk and a consequent reduction in the risk premium.

Our hypothesis is that the announcement of the reform should positively affect the prices of those stocks that can benefit from the reform. For example, a stock with a large proportion of NTS is typically associated with characteristics such as a small float, low turnover, high volatility, and weak corporate governance.

In this paper we evaluate the announcement effects of the reform by considering cross-sectional regressions of abnormal returns on firm variables related to their corporate governance (e.g. the proportion of shares held by non-controlling blockholders and board characteristics), ownership structure and stock market characteristics (e.g. liquidity) measured *before* the event period. We also use a portfolio time-series

¹ See Sun and Tong (2003) for a detailed explanation of NTS.

² Ownership diversification is one of the essential step toward the development of a more mature and representative stock market in China, OECD Economic Surveys: China, 2010.

³ This has been the experience in many developed and developing countries in which privatisation has been found to improve firm profitability, real output and efficiency, see Megginson and Netter (2001) and Kikeri and Nellis (2004) even though Calomiris et al. (2010) point out that in the Chinese case privatization may be associated with a reduction in profits.

⁴ A negatively sloped demand function would require a decrease in the equilibrium price to absorb the new supply, but Hong et al. (2006) show that expectations of future supply shocks may be beneficial to current stock prices.

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