Are the Chinese Listed Firms Expropriated by The Controlling Shareholders in Asset and Share Acquisitions?

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ABSTRACT

From the angle that tunneling in assets or shares acquisitions is in fact that the controlling shareholders transfer resources from purchasers to bargainors inside groups, We compare the performance change of listed firms that acquire assets or shares inside groups with that of listed firms that acquire assets or shares outside groups and find the former is significantly worse than the latter. Besides, we examine the stock price changes of purchasers and responding bargainors when the acquisitions occur and find that among acquisitions inside groups while the stock price of purchasers decrease significantly , the stock price of bargainors increase significantly ,but among acquisitions outside groups the stock prices of purchasers and responding bargainors do not change significantly. These suggest that there exist in the controlling shareholders expropriate the listed firms by the assets and shares acquisitions inside groups in China.

Keywords: acquisitions, expropriate, performance

1. INTRODUCTION

Tunneling, defined as the transfer of assets and profits out of firms for the benefit of the controlling shareholders, is firstly coined by Johnson et. al. (2000). It can take many forms, such as selling inputs or purchasing outputs at nonmarket prices, or high or low interest rate loans and so on. After the notion is coined, searching the evidence on tunneling becomes the hot topic some researchers take attention to and some achievements has been achieved. While at the present time, Chinese researchers justly get very limited achievement. If prevalent, tunneling may have serious consequences. By reducing the returns of minority shareholders, it can hinder equity market growth and overall financial development. Mullainathan et al(2000) suggest illicit profit transfers may also reduce the transparency of the entire economy, clouding the accounting numbers and complicating any inference about firms' health.To research on tunneling and prevent tunneling not only protect the benefits of minority shareholders ,but also contribute to the healthy growth of companies and entire economy.

Some foreign researchers(Boe,Mengoli,et al) have found controlling shareholders expropriate minority wealth by merge and acquisition. In China , Li et al(2005) preliminarily find controlling shareholders may expropriate minority shareholders by merge and acquisition. I'll examine whether controlling shareholders of Chinese listed firms expropriate minority shareholders by asset and share acquisitions from another more direct angle in this paper. Comparing with previous researches , this paper directly suggests Chinese listed firms' controlling shareholders expropriate minority shareholders by asset and share acquisitions inside groups and analyse the changes of the minority shareholders' wealth in both purchasers and bargainors. I think in fact tunneling by merge and acquisition is the controlling shareholders or the other firms controlled by the same controlling shareholders sale shares and assets to the listed firms at higher price (than the real value) in their business groups (the assets and the companies the shares present are probably ill assets and companeis).So, according to the bargainors are whether the members of the groups the listed companies belonged to (the members are the ultimate owners or the other firms controlled by the ultimate owners) or not, I will divide the assets and shares acquisitions (purchaser is listed firm) into two types: the first type is that the bargainor is the purchaser's ultimate owner or the other firm controlled by the same ultimate owner (I call this type of acquisitions acquisitions inside groups. The other assets and shares acquisitions belong to the second type , I call it acquisitions outside groups. Then I examine the two types of acquisition performances and compare the differences. The results provide the evidences of tunneling by means of assets and shares acquisitions in Chinese listed firms.

The remainder of the paper proceeds as follows. Section 2 reviews the related literatures. In Section 3, theoretical analysis and main hypotheses are presented. We discuss the sample and the research methodology in Section 4. The results are presented and analyzed in Section 5. We conclude in Section 6.

2 . LITERATURE REVIEW

La Porta et al. (1999), Claessens etal. (2000), Faccio and Lang (2002) and Dyck and Zingales (2004) find widely held firms, which are the norm in the U.S. and the U.K, are not prevalent in most other countries ,particularly in East Asia, where closely-held firms dominate the economic landscape and suggest that the main agency problem outside the U.S. and the U.K. is not the manager-shareholder conflict but rather the risk of expropriation by the dominant or controlling shareholder at the expense of minority shareholders.Under these research conditions, many foreign scholars make some studies on tunneling. Bertrand et al (2002) for example, examine tunneling activities within Indian business groups by tracing the propagation of earnings shocks from group firms where the controlling shareholders have low cash flow rights to firms where they hold high cash flow rights. They show that this propagation takes place through nonoperating earnings items. Bae et al (2002) examine rescue mergers within Korean industrial groups (chaebols). They find that the stock price of Korean companies affiliated with chaebols declines when they are asked to bail out other under-performing firms in the group through rescue mergers, while at the same time the value of the remaining firms in the group increases. In contrast, Buysschaert et al(2002) examine the valuation effects of transfers of equity stakes by firms belonging to Belgian business groups during the late 1990s but fail to find any expropriation of minority shareholders.

The condition of concentrated ownership is also of particular significance in Chinese listed firms. According to Li et al(2004),the largest shareholder holds about 44.4% of total shares of listed firm in 2003,while all the secondly to fifthly largest shareholders justly hold 14.8%.Chen(2005) finds the transactions of assets and shares have the largest number in all kinds of big connected transactions during 1998-2002.Under the conditions, a few of Chinese scholars began to make limited several empirical study. Li et al(2004) make a research on the listed firms' fund occupancy by the largest shareholders and find with the increase of shares holded by the controlling holders, the funds occupied firstly increase then decrease. Li et al (2005) compare the merge and acquisition performance of Chinese listed firms with the purposes of making up the deficits and maintaining listing qualification or rights offering with that of Chinese listed firms without the above purposes. The results suggest the merge and acquisition performance of firms with the above purposes is significantly positive, while the merge and acquisition performance of firms without the above purposes is significantly negative.

3.THEORETICAL ANALYSIS AND MAIN HYPOTHESES

The Chinese conditions of the faulty laws and systems, the share concentration and the coexistence of negotiable and nonnegatible shares in listed firms make the controlling shareholders have the strong incentive and power to expropriate minority shareholders. As one very important kind of connected transaction, the asset and share acquisitions possibly become one way of expropriation of minority shareholders by the controlling shareholders in considerable degree. The controlling shareholders or the other firms(in which the same controlling shareholders hold higher cash flow right) sale shares and assets to the listed firms at higher price (than the real value) inside their business groups(the assets and the companies the shares present are probably ill assets and companeis), then the profitability and the value of the listed firms will decrease. In contrast, the profitability and then the value of the bargainors will increase. But, tunneling doesn't exist in acquisitions outside groups , so, under the condition in which controlling the other things same, the acquisition performances of the listed firms which acquire assets or shares outside groups are better than that of listed firms which acquire assets or shares inside groups. La Porta et al. (1999), Claessens et al. (2000), Faccio et al (2002) and Dycket al(2004) suggest that the main agency problem outside the U.S. and the U.K. is not the manager-shareholder conflict but rather the risk of expropriation by the controlling shareholder at the expense of minority shareholders. So, in spite of the existence of manager agency problems in acquisitions outside groups, the acquisition performance and then the value of the listed firms which acquire the assets or shares outside the controlling shareholder groups will not decrease or even though decrease , the decrease will be less than that of the listed firms which acquire the assets or shares inside the controlling shareholder groups because of the same existence of manager agency problem in these listed firms. Similarly , the performance and then value of bargainors in the acquisitions outside groups will not observably increase , even though increase, the increase will be less than that of the listed firms which acquire the assets and shares inside groups.

If the level of profitability of the listed firms is higher, the controlling shareholders will have stronger incentive to expropriate the listed firms and these acquisitions are more possibly the means by which the controlling shareholders expropriate the listed firms. However , if the profitability of the listed firms is low, the controlling shareholders will not have strong incentive to expropriate the listed firms , moreover, even when the profit of the listed firms is negative , the controlling shareholders support them to main the listed qualifications in order to make expropriations in the future. So, after acquisitions inside groups, the performances of the listed firms with high past profitability will decrease more than that of the listed firms with lower past profitability do. As to acquisitions outside groups, though the managers of listed firms with high past profitability have more money to expand for their own, the performance of listed firms with high past profit level will not decrease or decrease less than that of listed firms with the same high past profitability but making acquisitions inside groups does and the difference between the performance decrease of listed firms with high past profitability and making acquisitions outside groups and the performance decrease of listed firms with low past profitability and making acquisitions outside groups should be not less remarkable than those in acquisitions inside groups for the reasons that main agency problem is not the manager-shareholder conflict , the same manager agency problems also exist in the listed firms making acquisitions inside groups and the high profitability of firms suggests that the managers are competent and can well select and consociate the targets. Because the controlling shareholders have no strong incentive to expropriate the listed firms with low past profit level, the acquisition performances of firms with low past profitability and making acquisitions inside groups don't remarkably differ from those of firms with low past profitability and making acquisitions outside groups.

According to the above analyses, we put forward the following hypotheses:

H1: the performance change of the acquirers brought by acquisitions inside groups is significantly worse than that of the acquirers brought by acquisitions outside groups .

H2: Among acquisitions inside groups, the acquisition performance of purchasers with high past profitability is significantly less than that of purchasers with low past profitability. But there is not this pattern among acquisitions outside groups.

H3: The acquisition performance of purchasers (acquisitions inside groups)with high past profitability significantly underperform the purchasers (acquisitions outside groups) with high past profitability . But there is not this pattern among acquisitions outside groups.

H4: Among acquisitions inside groups, the stock price of purchasers significantly decrease while the stock price of bargainors significantly increases when the acquisitions occur. But the stock prices of both purchasers and bargainors don not change significantly among acquisitions outside groups.

4. SAMPLE AND METHODOLOGY

4.1.Sample

From the CSMAR Database and all kinds of pronunciamentos from the websites of the Shanghai stock exchange, the Shenzhen stock exchange ,Sina and the relative companies, we select and collect the data and sample satisfying the following criterions: A, the sum of the asset or share acquired is in excess of 4% of acquirer's total asset; B, from the 1year before to 2 years after the year of acquisition, there are no other important asset (or share) exchanges or sales(the sum of the exchanges(or sales) is in excess of the sum of the selected acquisition);C, after classifying the selected acquisition into the type of acquisitions inside groups or the type of acquisitions outside groups, we separately add up all the acquisitions from the 1year before to 2 years after the year of acquisition according to the type of acquisitions and then compare the two sums, the sum of another type of acquisitions (the acquirer acquires during the 4 years) isn't in excess of 10% of the sum of the type of acquisitions(the acquirer acquires during the 4 years) the selected acquisition belongs to. D, the sum of all the other acquisitions (which belong to the same type of acquisition as the selected acquisition does) the acquirer acquires during the 4 years is less than 50% of the sum of the selected acquisition.(in order to control the effects of characters such as industry relatedness ,scale, etc on acquisition performance) E, during the 4 years, if two or more acquisitions have not only the same purchaser and bargainor but also the same firm's shares or assets with the same use, we take them as one acquisition; F, as to acquisitions inside groups, the controlling shareholders have higher cash flow rights in purchasers than that in bargainors; G, the purchaser is one listed firm. As a result , we get 176 acquisitions(responding 176 listed firms) where 115 acquisitions are acquisitions inside groups taking place in the period from 2000 to 2002. The mean cash flow right the controlling shareholders owned in purchasers is 50.1% ,while the mean cash flow right the controlling shareholders owned in bargainors is 95.8% .The difference between the two mean values is considerable. This suggests that the controlling shareholders have strong incentive to transfer resources from purchasers to bargainors.

In all asset and share acquisitions taking place from 2000 to 2002(of course including the 176 acquisitions), there are only 17 acquisitions in which the both purchasers and bargainors are listed firms . We examine the annual reports and pronunciamentos declared by all purchasers and bargainors, none of them satisfies all the above 7 criterions. So, in order to get the more convincing evidences that the controlling shareholders transfer resources out of the purchasers and examine the value changes of the both sides, we have to examine the short performance changes (brought by the acquisitions) of the purchasers and bargainors instead of examining the long performance changes of both sides and select another assistant sample for these examinations. In order to get the assistant sample, firstly, we collect all the asset and share acquisitions in which both purchasers and bargainors are listed firms from 1998 to 2003(extending the period is to augmenting the assistant sample); secondly, we deleting every acquisitions in which either of purchaser and bargainor declare the other important pronunciamentos (such as other important acquisitions, lawsuits, contract signing,etc)from the 50 days before to the 50 days after announcement date of acquisitions ;finally, we get 6 acquisitions inside groups(the controlling shareholders have higher cash flow rights in purchasers than that in bargainors) and 8 acquisitions outside groups.

4.2Methodology

There are two main methods of computing the acquisition performance. The first one is to compute the cumulative abnormal return during some days around the announcement date. Because application of the method is subject to the efficiency of stock market and even the weak efficiency of Chinese stock market is suspicious, we will compute the performance changes by means of the second method, that is to use the financial ratios to measure the performance changes.

According to research target of this paper, we select the following 4 financial ratios which largely reflect the profitability : return on sale(ROS), return on assets(ROA), return on equity (ROE),and earnings per share (EPS).In order to eliminate the effects of the industry, we respectively subtract the responding industry mean from the 4 financial ratios. For the sake of comparing the performance changes around the acquisitions, we extract 4 common components from the 4 new financial ratios (after industry adjustment) by factor analyse method (principal component method) and condense them into one synthesized score by means of the following formula :

$$F_i=a_{ij}Y_{ij}+a_{ij}Y_{ij}+a_{ij}Y_{ij}+a_{ij}Y_{ij} \quad (1)$$

F_i is the synthesized score of firm i, a_{ij} is the proportion of variance that the component j of firm i contributes to explain， Y_{ij} is the score of the component j of firm i.

We have to measure the effect of the acquisitions on both purchasers and bargainors from the short term by means of the assistant sample, so, we measure the performance changes by computing the cumulative abnormal return(CAR) around the announcement date instead of the above financial ratios method. For each firm, we obtain the estimates a^ and b^ of a and b in $R_{it}=a+bR_{Mt}$ by using 200 trading days of return data, from trading days -240 until-40(R_{it} is the daily return of firm i at time t， $R_{Mt}$is the daily return of responding Shanghai or Shenzhen market at time t).We compute the abnormal return of firm i at time t by $AR_{it}=R_{it}-(a\hat{}+b\hat{}R_{Mt})$ and CAR of firm i at the event window (t1,t2) by$CAR(t1,t2)=\sum_{t1}^{t2} ARRt$ (We note the day t before announcement date as t and the day t after the announcement date as –t.)

5. EMPIRICAL RESULTS

5.1 Performance changes brought by acquisition inside groups and performance changes brought by acquisition outside groups

We compute the synthesized score of acquirer i in the 1 year before acquisition, the acquisition year, the 1year and 2 year after acquisition, $F_{i,-1}$， $F_{i,0}$， $F_{i,1}$， and $F_{i,2}$ .The F_0-F_{-1}， F_1-F_{-1} , F_2-F_{-1} is the performance changes of firm i in the acquisition year, the 1year and 2 year after acquisition relative to the performance in the 1 year before acquisition. In order to avoid the effects of extreme values, we delete the upper and the lower 3% of the synthesized scores at the same time and finally get 166 acquisitions(including 109 acquisitions inside groups).The table1 suggests that the mean performance of the whole sample firms decrease after these acquisitions, but the results are not significant. The mean performance of firms that acquire assets or shares inside groups decreases significantly in the 1 year and 2 year after these acquisitions. While mean performance of firms that acquire assets or shares outside groups increases (though insignificantly) in the 1year and 2 year after these acquisitions. This suggests that the negative change are mostly from the firms that acquire assets or shares outside groups. We compare the difference of performance changes between the two types of firms and find that acquisition performance of the firms that acquire assets or shares inside groups is significantly less than that of the firms that acquire assets or shares outside groups. Theses results to a great extent suggest that the controlling shareholders transfer resources from the purchasers by acquisitions.

Table 1 Performance changes brought by the two types of acquisitions

Performance changes	Total firms (mean)	T	Firms I(A) (mean)	T	Firms II (B) (mean)	T	Difference of changes(A-B)	T
F_2-F_{-1}	-0.03252	-1.157	-0.09518	-2.096**	0.08731	1.328	-0.18248	-2.204**
F_1-F_{-1}	-0.02142	- 0.897	-0.07203	-1.71*	0.07535	1.216	-0.14739	-1.813*

Note：*，**，***reprent significance at the 10%，5%，1% level. Firms I reprents firms that acquire assets or shares inside the controlling shareholder groups. Firms II reprents firms that acquire assets or shares outside the controlling shareholder groups. The meanings that *， **， ***, Firms I and Firms II represent in the following is same as the above meanings.

5.2 Past profitability and acquisition performances

As past profitability variable, we use the ROE of acquirer in the year before acquisition. We further divide the two types of acquirers into four groups according to the median of their past profitability. From the table 2, we find that among Firms I the performance of the firms with high past ROE decrease significantly, while that of the firms with low past ROE increase and the difference between the firms with high past ROE and the firms with low past ROE is very significant. However, we do not find the same pattern among Firms II . Comparing the two groups of acquirers with high past profitability shows that acquirers among Firms I significantly underperform the acquirers among Firms II .In contrast, for acquirers with low past profitability, we do not find such a pattern. This suggests that the controlling shareholders mostly transfer resources from the acquirer with high past profitability. Combining table1 with table 2, we deduce that though sometimes the controlling shareholders do not siphon resources out of the firms in bad financial condition and even favor them, on the whole, the target of the controlling shareholders is to transfer resources from the acquirers (listed firms).

table2 F_2-F_{-1} and the ROE of the firms in the year before acquisitions

ROE	number of firms	Firms I(A) (mean)	T	number of firms	Firms II (B) (mean)	T	Difference of changes(A-B)	T
above median	55	-0.26293	-3.757***	29	0.00927	0.353	-0.2722	-2.514**
below median	54	0.07568	1.692*	28	0.16813	1.17	-0.09245	-0.646
Difference (above-below)		-0.33861	-3.638***		-0.15885	-1.129		

5.3 performance changes of both purchasers and bargainors

In order to get evidences to testify that the controlling shareholders siphon resources out of the acquirers by acquisitions, we use the assistant sample(for acquisition inside groups, the controlling shareholders have higher cash flow rights in purchasers than barginors) to compute the cumulative abnormal return of both purchasers and bargainors from the 30 day before to 30 day after the announcement date CAR(-30,30) . To perform the test, we use the standardized t-test (two-sided), described in Brown and Warner (1985). From the table 3, we find that among acquisitions inside groups, the CAR(-30,30) of the barginors is significantly positive and the CAR(-30,30) of the purchasers is significantly negative. These suggest that these acquisitions decrease the value of purchasers and increase the value of barginors. Among acquisitions outside groups , the CAR(-30,30) of both purchasers and bargainors do not significantly differs from 0. These further confirm that the controlling shareholders transfer resources from purchasers to bargainors(in which the controlling shareholders have more cash-flow rights) by acquisitions.

Table 3 CAR(-30,30)of both purchasers and bargainors

	number of firms	Firms I (mean)	T	number of firms	Firms II （mean）	T
purchaser	6	-0.09107	-2.517**	8	-0.03085	-1.134
barginor	6	0.04369	2.101*	8	0.00579	0.347

5.4 Cross-sectional regression analysis

To control the effects of other factors on the acquisitions and confirm that the controlling shareholders transfer resources from listed firms(which are acquirers) ,we present the examinations from multivariate regressions. We model the regressions as follows:

F2-F-1= α + β 1D1+ β 2 Scale+ β 3 Relate+ β 4 CEO+ β 5 Categy (2)

F2-F-1= α + β 1D2+ β 2 Scale+ β 3 Relate+ β 4 CEO+ β 5 Categy (3)

F2-F-1= α + β 1D3+ β 2 Scale+ β 3 Relate+ β 4 CEO+ β 5 Categy (4)

F2-F-1= α + β 1D4+ β 2 Scale+ β 3 Relate+ β 4 CEO+ β 5 Categy (5)

F2-F-1= α + β 1D5+ β 2 Scale+ β 3 Relate+ β 4 CEO+ β 5 Categy (6)

Where D1 is dummy for acquisitions inside the controlling shareholder groups. D2 is dummy for acquirers the ROE in 1 year before acquisitions of which are than the median among Firms I. D3 is dummy for acquirers the ROE in 1 year before acquisitions of which are than the median among Firms II. D4 is dummy for acquirers that acquire assets or shares inside groups among the sample consisted of firms for which D2 equal 1 and firms for which D3 equal 1.D5 is dummy for acquirers that acquire assets or shares inside groups among the sample consisted of firms for which D2 equal 0 and firms for which D3 equal 0.The relate, Scale, CEO and Categy are used to control the effects of industry relatedness, acquisition scale , managerial capacity change of CEO and whether thing acquired is asset or share on the acquisition performances. From the regression results in table 4,we find that the coefficients of D1 (in regression(2)), D2 (in regression (3)) and D4(in regression(5)) are all significant and negative values. , In regression(4),D3 has a negative coefficient, but it is only significant at 10 percent level. In contrast, in regression(6), D5 has a insignificant negative coefficient. These results are consistent with the prior univariate results. All these verify that asset and share acquisitions is one way by which the controlling shareholders transfer resources from the listed firms in China.

Table 4 Regression results

Variable	Regression (1)	Regression (2)	Regression (3)	Regression (4)	Regression (5)
α	0.05379 (0.573)	-0.00987 （-0.075）	0.171 （1.181）	-0.228* （-1.676）	0.323 （0.841）
D1	0.178** (-2.011)				
D2		-0.33*** （-3.349）			
D3			-0.338* （-1.701）		
D4				-0.241** （-2.18）	
D5					-0.201 (-1.271)
Scale	0.372* （1.693）	-0.319 （-0.879）	0.635** （2.223）	0.526* （1.915）	0.213 (0.576)
Relate	0.0464 （0.529）	0.00419 （0.087）	0.6923 （0.831）	0.0857 （0.764）	0.118 (0.898)
CEO	-0.096 (-1.203)	-0.015 （-0.159）	-0.339** (-2.607)	0.0186 （0.195）	-0.299** (-2.44)
Catgy	0.0418 （0.525）	0.04457 （0.481）	0.22 (1.533)	0.04419 （0.413）	0.177 (1.579)
Adjusted R square	0.084	0.09	0.179	0.101	0.121
Number of firms	166	109	57	84	82

6.CONCLUSION

After acquiring assets or shares from the controlling shareholders or the other firms in which the controlling shareholders have higher cash flow rights, the performance of firms significantly decrease in the following 1 year and 2 year. While the performance of firms which acquire assets or shares outside groups increase in the following 1 year and 2 year. By focusing on the performance change from the 1year before to 2 year after acquisitions, we further find that among acquisitions inside groups, the acquisition performance of acquirers with high past profitability is significantly less than that of acquirers with low past profitability. There is not such significant pattern among acquisitions outside groups. The acquisition performance of acquirers with high past profitability and acquire assets or shares inside groups significantly underperform acquirers with low past profitability but acquire assets or shares outside groups .In contrast, for acquirers with low past profitability,there is not such a pattern. We also find that among acquisitions inside groups, the value of bargainors significantly increases and the value of responding purchasers significantly decreases during 61 days around announcement date. While among acquisitions outside groups, not only the value of purchasers but also the value of bargainors do not change significantly. All of these are consistent with our four hypotheses. These testify that there exist in the controlling shareholders expropriate the listed firms(the acquirers) by the assets and shares acquisitions inside groups in China. And the results suggest that the shareholders mostly transfer resources from the firm with high past profitability.

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