Do Ownership Ties and Board Ties to Government Affect Firm Value? Evidence from an Emerging Market Event Study

Pei Sun*, Haoping Xu
School of Management, Fudan University
Shanghai, China

ABSTRACT

This paper aims to examine the value of business-government ties in emerging economies undergoing fast liberalization and transition. To accomplish this, we document stock market responses to an unanticipated arrest of Shanghai's top leader by the Chinese central government in September 2006. For a sample of Shanghai-based publicly traded companies, we identify ownership ties and board-level ties to the local state for each firm. Firms with local political ties suffered on average -2.1% cumulative abnormal return (CAR) over the event window (-1, 3). Multivariate regression analysis shows a negative effect on firm value of both board ties and non-controlling ownership ties to the municipal government, while the association between the presence of ultimate controlling ownership ties and firm value was statistically insignificant. Further, a positive interaction effect on CARs occurred between board ties and non-controlling ownership ties. These empirical findings shed light on how the benefits and risks of different types of business-government ties evolve during deep liberalization and institutional reform.

*Corresponding author: 670 Guoshun Road,
School of Management, Fudan University
Shanghai, China 200433
Email: sunpei@fudan.edu.cn
+86 21 2501 1114 (Phone)
+86 21 6564 2411 (Fax)

INTRODUCTION & HYPOTHESES

This paper intends to make two interrelated contributions to the extant literatures of strategic networks and business-government relationships. First, it presents a disaggregate analysis of the value of business-government ties in an emerging market, which is particularly underexplored in comparison both with the U.S. context and with the studies of the interfirm ties. Second, the research findings have important bearings on the heated debate about whether the value of business–government network ties rapidly declines or remains significant in emerging economies during transition and liberalization (Peng, 2003; Peng and Zhou, 2005; Michelson, 2007; Siegel, 2007). The empirical setting of this paper is Shanghai, the most developed city in mainland China in the second half of the 2000s, when China has already been experiencing deep liberalization since its WTO entry in 2001.

Specifically, the paper examines stock market reactions to a truly unexpected political event: the arrest of the top Communist official in Shanghai – Chen Liangyu – on September 24 2006, which signified a sudden crackdown of the Shanghai-based political clique from the central government. This research design offers notable advantages for addressing our research question. First, the event study approach largely overcomes the endogenity problem, since the unanticipated weakening, if not elimination, of the local political base allows for a cleaner measure of the lost value of firm-specific political capital that should be reflected in a company's stock price. Second, given that political ties have significant geographic origins (Faccio and Parsley, 2009), our focus on Shanghai-based firms reduces extraneous variation, such as the valuation effects of ties to central and other political authorities.

The conventional wisdom generally suggests a positive correlation between political network ties and organizational performance. Both the resource dependence theory (Pfeffer and Salancik, 2003) and the political resources literature (Hillman, Keim, and Schuler, 2004) indicate that political ties confers legitimacy, status, and access to valuable resources and information in a variety of forms. Empirical studies in the context of developed economies tend to confirm that the presence of ties to politicians and regulatory bodies generates a positive effect on firm value (Hillman, Zardkoohi, and Bierman, 1999; Hillman, 2005; Goldman, Rocholl, and So, 2009). For firms competing in emerging markets and transition economies, the case for painstaking cultivation of political networks may be more compelling, where the governments still control a wide range of financial and regulatory resources and maintain a tendency of expropriation. Correspondingly, the positive effects of political connections seem to be even more pronounced (Peng and Luo, 2000; Xin and Pearce, 1996; Fisman, 2001; Faccio, 2006). The development of connections to prevailing political leaders, networks, and regimes helps firms to generate political capital, which in turn may translate into higher profitability and company valuation through various forms. They include, but are not limited to, favorable access to bank loans, tax breaks, and preferential regulatory policies.

Despite the persuasive arguments for the benefits of political ties, they should be qualified with the potential harms they may generate over time. In recent years, a stream of studies has emerged examining the dark side of political ties. A firm's competitive advantage generated with the aid of political actors may be lost as a result of sudden changes in the political environment (Leuz & Oberholzer-Gee, 2006; Siegel, 2007), evolutionary changes in the business environment (Sun, Mellahi, & Thun, 2010), or intense bargaining over firm surplus between politicians and other corporate stakeholders (Sun, Mellahi, and Liu, 2010; Sun, Wright, and Mellahi, 2010). In terms of ownership ties, in parallel to the aforementioned benefits, the agency costs associated with controlling ownership ties to the government invite potential opportunistic behaviors such as fund diversion and asset stripping (La Porta et al., 2000; Young et al., 2008). When legal and regulatory constraints are largely ineffective, which is the norm rather than an exception in emerging economies, the government may be tempted to use the profitable firm as a social instrument for its own political and financial ends. In the end, the benefits and costs of this type of political ties may offset with each other. In contrast, having non-controlling ownership ties to the political authority is largely exempt from the problem, with benefits significantly higher the costs. In the case of board ties, research abounds on the benefits of personal connections such as *guanxi* with political actors (e.g., Luo, 2003). Summarizing the above arguments, the following hypotheses are developed for our empirical testing:

Hypothesis 1: Strong (*Controlling*) *ownership ties to the government do not have a significant impact on firm value in emerging economies undergoing deep economic liberalization.*

Hypothesis 2: Weak (Non-controlling) ownership ties to the government have a positive impact on firm value in emerging economies undergoing deep economic liberalization.

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Hypothesis 3: Board-level ties to the government have a positive impact on firm value in emerging economies undergoing deep economic liberalization.

EMPIRICAL SETTING

The local political economy in Shanghai, China makes the event an ideal context for our research. Typical of many Shanghai government officials, Chen had his entire public-sector career in Shanghai, starting from a factory manager in the 1970s to municipal Party secretary and a member of China's ruling Politburo since 2002. Thus, the presence of a cohesive local political network facilitated the emergence of what was known as "Shanghai Inc.". According to *Wall Street Journal*, "giant construction projects got funded from public coffers; choice assets moved out of state hands in elaborate transactions; and plum contracts went to the well-connected."[1] The fall of Chen, consequently, indicates a big blow not only to Chen and his associates, but also

[1] "Corruption Crackdown Targets Shanghai Inc." *Wall Street Journal*, February 7, 2007.

to the whole political network in Shanghai. On Monday, September 25 2006, *People's Daily*, the mouthpiece of the Chinese Communist Party, announced the dismissal and detention of Chen Liangyu in Beijing the day before, on the ground of his involvement in the Shanghai social security fund scandal. Information leakage is a minor concern as the purge of Chen was kept in strictly confidential. Chen made public appearance in Shanghai even on the evening of September 23.

DATA & VARIABLES OF INTEREST

A total of 142 companies were both floated on the Shanghai Stock Exchange and headquartered in Shanghai as of December 31, 2005. Stock price, accounting, and ownership data for these firms were obtained from the Sinofin database developed by the China Center of Economic Research, Peking University. After deleting firms without necessary data to calculate CARs, we have 137 firms for our empirical analysis. In terms of ownership ties, 70 companies held *ultimate* controlling ownership ties to the Shanghai municipal government, in the sense that local state-owned/controlled enterprises acted as these companies' intermediate controlling shareholders in the stock pyramids. For those without dominant ownership ties with the municipal government, 33 firms are found to have more or less non-controlling shareholding ties to the local state, compared to the rest 34 firms that have no ownership linkages to the local government at all. In this empirical study, we use two dummy variables **SOwnership_Tie** and **WOwership_Tie** to characterize the strong (controlling) ownership ties and the weak (non-controlling) ones, while the benchmark group contains the firms without any ownership linkages to the local state.

In light of personal connections to the local political network, we manually collected the career information of all the board members in the sample companies, which may be found in their annual reports in various years. In line with the identification of board ties in previous literature (Hillman, et al., 1999; Agrawal and Knoeber, 2001; Hillman, 2005; Lester, Hillman, Zardkoohi, and Cannella, 2008), a board tie is believed to be present in a company if at least one of its board members was currently or once a government official in Shanghai. Therefore, this specification allows for a comprehensive measurement of board links to the Shanghai-based political network. Again, we use a binary variable **Board_Tie** to denote the firms that had board-level connections to the local government. Following this procedure, we find that 87 out of our 137 firms fell into this category. A further breakdown of the sample firms is shown in Table 1, suggesting the prevalence of local political ties in the Shanghai-based listed firms: Only 23 out of 137 firms did not have shareholding or board-level links to the local government.

Standard event study methodology is used to estimate CARs. We first run the following market model for daily returns: $R_{it} = \alpha + \beta_i R_{mt} + \varepsilon_{it}$, where R_{it} is the rate of return for stock i at time t, and R_{mt} is the rate of return on the market portfolio m at time t. The estimated intercept and coefficient prior to the unanticipated event are applied to calculate the abnormal return [$AR_{it} = R_{it} - (\hat{\alpha} + \hat{\beta} R_{mt})$] for each company. Cumulative abnormal returns of each company over the event windows (-1, 2) and (-1, 3) – CAR_i (-1, 2) and CAR_i (-1, 3) – then are obtained through algebraic aggregation, with September 25 2006 treated as day 0.

Table 1 Distribution of Sample Firms by Ownership and Board Ties

	Presence of strong ownership ties	**Presence of weak ownership ties**	**Absence of ownership ties**	**Total**
Presence of board ties	61	15	11	87
Absence of board ties	9	18	23	50
Total	70	33	34	137

RESULTS

Preliminary examination of stock market responses to the sudden removal of Chen is shown in Table 2, which presents a classification of sample firms into two broad categories: Those with ownership and/or board ties to the local political authority and those without. Clearly, the stock market discounted the politically-connected group with a 0.9% or 2.1% decline in CARs depending on the event window chosen. Meanwhile, the latter group on average enjoyed a 2.6% or 1.4% rise in company value at respective event windows, and the difference between the two groups is statistically significant.

Table 2 Univariate Comparison of CARs for Firms with and without Local Political Ties

Firm Types	**Mean**		**t-statistics**	
	CAR(-1, 2)	CAR (-1, 3)	CAR(-1, 2)	CAR (-1, 3)
Firms with local political ties (n = 114)	-0.009	-0.021	-2.430***	-2.606***
Firms without local political ties (n = 23)	0.026	0.014		

After controlling for other variables that may potentially affect firm valuation (size, profitability, growth opportunities measured by Tobin's Q, industry affiliation, and whether a firm was directly involved in Chen's scandal), we perform multivariate regression analysis of the relationship between firm-level CARs and local political ties at both the organizational and personal levels, the results of which are presented in Table 3.

Column (1) shows a preliminary analysis of the valuation effect of ownership and board ties. The presence of board ties to the local political network exhibits a significantly negative effect on firm value after the event, but the ownership ties, whether strong or weak, seems to have no impact. This result is at best preliminary in that important interaction effects between ownership ties and boards are not taken into account.[2] After including two interaction variables in column (2) and further adding control variables in column (3), the estimated coefficient on strong (controlling) ownership ties remains insignificant. This confirms our hypothesis that having controlling ownership ties to the local government may not affect market evaluation, as investors may believe that the coexistence of benefits and costs of these ties leads the net effect to be insignificantly different from zero before the event.

Table 3 Multivariate Regressions of CAR (-1, 2) on Local Political Ties

	(1)	(2)	(3)
INTERCEPT	0.018** （2.277）	0.026*** （2.935）	0.055 (0.851)
Board_Tie	-0.018** （-2.026）	-0.045*** （-2.735）	-0.041** (-2.308)
SOwnership_Tie	-0.014 （-1.368）	-0.019 （-1.129）	-0.025 (-1.405)
WOwnership_Tie	-0.010 （-0.950）	-0.030** （-2.215）	-0.033** (-2.309)
Board_Tie*SOwnership_Tie		0.023 （1.005）	0.028 (1.197)
Board_Tie* WOwnership_Tie		0.052** (2.335)	0.052** (2.233)
ROA			-0.087 (-1.567)
LNSIZE			-0.001 (-0.359)
Tobin's Q			0.001 (0.271)
INVOLVE			0.008 (0.376)
INDUSTRY			Controlled
Number of Observations	137	137	137
Adjusted R2	5.9%	8.4%	6.5%

Notes: INVOLVE is a dummy variable equal to 1 if a firm is directly involved in the scandal leading to the removal of Chen Liangyu, 0 otherwise. Tobin's Q is a proxy of the stock market's evaluation of a firm's future growth opportunity. SIZE is the natural logarithm of a firm's sales revenues in year 2006. ROA is a firm's return on assets in year 2005. INDUSTRY is the standard dummy variables controlling for industry-specific effects. *t*-statistics are reported in parentheses,

[2] As can be seen in table 1, there is a significant overlap between the two types of ties in the Shanghai-based companies.

with *, **, and *** marking significance at the 10%, 5%, and 1% levels respectively.

In contrast, both weak (non-controlling) ownership ties and board ties show significantly negative impacts on firm value, which suggests considerable strategic value of these ties in Shanghai before the political shock. In the case of former ties, the result confirms our conjecture that the benefits of having non-controlling ownership ties outweigh the costs of them, as this arrangement does not in general result in large shareholder expropriation by the local government. In the latter case, the result indicates a considerable value of personal-level political capital before the event, and the persistence of a relationship-based system even in China's most developed region in the mid 2000s.

CONCLUSION

Taking advantage of an unanticipated political event in an emerging market as a natural experiment, this paper investigates the value of various types of business-government ties in an economy undergoing deep economic liberalization. Event study results show that controlling ownership ties *per se* were not valued by investors, while non-controlling shareholding ties and board ties to the local state were valuable indeed prior to the political shock: Following the arrest of the local leader, the presence of either of two types of ties is found to be associated with statistically and economically significant negative CARs. In sum, this study enriches our understanding of the strategic importance of the interorganizational and interpersonal ties to political networks in general, and the benefit and costs of them in particular, in emerging economies.

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