Are future capital gain opportunities important in the market for corporate control? Evidence from China

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ABSTRACT

Stock prices of Chinese target companies react positively to the announcement of block trades. Such a reaction is greater when publicly tradable shares (PTS) are transferred than when bidders obtain nonpublicly tradable shares (NPTS). PTS transactions also perform significantly better in the long run than do NPTS transactions. These results suggest that stock liquidity matters for corporate control rights transactions to improve target firms’ management. We also find that bidders appoint a new CEO or chief director in more than half of the cases of block trades. Better stock price performance for PTS transactions comes mainly from targets with high Tobin’s Q. Capital gain opportunities are likely to motivate bidders to expand target firms’ businesses for capital gains.

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1. Introduction

This paper examines whether stock liquidity affects the market functions for corporate control. Corporate control rights transactions serve as an important external corporate governance mechanism that achieves an efficient allocation of control rights. Recent studies provide evidence that block purchases of stocks create value for the shareholders of target companies (Brav et al., 2008; Klein and Zur, 2009).

Stock liquidity affects corporate control rights transactions through several potential mechanisms.1 First, liquidity enables investors to purchase a block of shares to obtain the control rights of the target company (Kyle and Vila, 1991; Kahn and Winton, 1998; Maug, 1998; Edmans et al., 2013). Conditional upon control rights being transferred, liquidity allows the blockholder to earn capital gains from value-creating intervention, which motivates bidders to actively monitor the target’s management (Maug, 1998; Faure-Grimaud and Gromb, 2004) (hereafter, this aspect is denoted as active monitoring view). Meanwhile, recent research stresses that stock liquidity generates the threat of blockholders’ exit, which effectively disciplines management (Admati and Pfeiderer, 2009; Edmans, 2009; Edmans and Manso, 2011; Edmans et al., 2013). Liquid stocks enable

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1 On the contrary, earlier studies argue that liquidity is bad for blockholder governance because it allows blockholders to sell their stakes in a troubled firm rather than bear the cost of actively monitoring the firm (Coffee, 1991; Bhide, 1993).

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stock sales by informed blockholders, which drive down the stock price and thereby damage the wealth of managers compensated with equity-based compensations. According to this view, managers of companies with block shareholders conduct value-increasing behaviors, even without active monitoring by blockholders (hereafter denoted as exit threat view).

Generally, endogeneity problems introduce difficulty in examining the effect of share liquidity on the market function for corporate control (Bharath et al., 2013). Our paper addresses this issue by examining Chinese data. Chinese firms generally have concentrated ownership structures, in which the government or government-related agencies take significant equity stakes in firms. Previous studies suggest that ownership structure is a significant factor associated with Chinese corporate performance. In addition, Chinese listed firms have adopted the split-share structure, in which their shares have been split into two types upon tradability in the secondary market: publicly tradable shares (PTS) and nonpublicly tradable shares (NPTS) (Wei and Xiao, 2009; Firth et al., 2010; Huang et al., 2011; Li et al., 2011). Controlling shareholders of Chinese companies typically hold NPTS, which cannot be traded in the secondary market. This means Chinese bidders must privately negotiate with the controlling shareholders of target companies (negotiated transaction) to obtain a firm’s control rights. Bidders of NPTS transactions inevitably hold illiquid stocks and have extremely limited opportunities to realize capital gains (Dong et al., 2014). Although negotiated transactions provide them with opportunities to achieve capital gains, approval from the China Securities Regulatory Commission (CSRC) or the state-owned Asset Supervision and Administration Commission is required to implement negotiated transactions. A novelty of Chinese data is that the split-share structure reform, which started in 2005, forced listed companies to convert NPTS to PTS. As a result, many control rights transactions in China began to transfer PTS, which are much more liquid than NPTS. This remarkable institutional change enables us to investigate the effect of stock liquidity on the function of control rights transactions.

We examine 234 block trades in China, which were formally announced between 2003 and 2009. Consistent with the previous US research, we find a positive stock price reaction for target firms in the few days surrounding the initial announcement of block trades. Shares of target companies also outperform matched companies in the long run. Importantly, both short- and long-term stock price performances are significantly better in PTS transactions than in NPTS transactions. These results are robust after controlling for the bidding price, which is far lower than the market price, especially in NPTS transactions, firm characteristics, and potential endogeneity problems. Overall, our results support the idea that stock liquidity is an important factor for corporate control rights transactions to serve as an important corporate governance mechanism.

The two views on mechanisms through which stock liquidity improves the outcome of control rights transactions, our findings are more consistent with the active monitoring view. Both for PTS and NPTS transactions, more than 80% of bidders hold shares of target companies three years after the formal announcement (execution). This finding suggests that Chinese bidders are likely to be long-term investors. In addition, the bidder appoints the new CEO or chief director in more than half of negotiated transactions (the CEO or chief director is replaced in more than 70% of the deals). Those figures suggest that Chinese bidders, most of which are nonfinancial corporations, can actively monitor management. Meanwhile, we find that targets of PTS transactions increase their assets in the post-block trade period more than those of NPTS transactions. We propose that increased capital gain opportunities incentivize PTS bidders to expand the firm’s businesses. Indeed, we find that the positive stock price reaction to announcements of PTS transactions is especially the case with regard to targets that have rich growth opportunities. Considered together, our results provide evidence that stock liquidity, or capital gain opportunities, enhances the disciplinary effects of control rights transactions as well as risk-taking behaviors.

This paper makes substantial contributions to the literature. Although previous studies mainly investigate takeovers in developed countries (Brav et al., 2008; Klein and Zur, 2009), we show evidence that corporate control rights transactions work as an effective corporate governance mechanism in China, where serious expropriation problems exist (Chen et al., 2009; Firth et al., 2006; Gul et al., 2010; Jiang et al., 2010; Wang, 2005; Wei and Xiao, 2009; Zou et al., 2008). Recent papers examine the relation between institutional ownership and firm value after an exogenous shock, which substantially changes stock liquidity (Bharath et al., 2013; Edmans et al., 2013). We apply their research methodology to China, which conducted a novel reform regarding stock liquidity.

Our results also indicate that developing liquid stock markets contributes to well-functioning external corporate governance mechanisms. Recent studies document evidence of positive effects from the split-share structure reform. Chen et al. (2012) find that the average Chinese firm decreased cash holdings after the split-share structure reform, suggesting that the reform mitigated agency conflicts arising between controlling and minority shareholders. Li et al. (2011) show evidence that NPTS holders provide high compensation to PTS holders when the firm has a high idiosyncratic risk, suggesting that the split-share structure reform enhances efficient risk sharing among shareholders. Liao et al. (2014) find that Chinese state-owned enterprises (SOEs) significantly increased output, profit, and employment after the reform without reducing operating efficiency. The authors find a positive relation between the post-reform performance improvement and the government agent’s supportive activities, suggesting that the reform aligns the interests of the government and minority shareholders. In line with these studies, we argue that the split-share structure reform enhances the disciplinary roles of the market for corporate control.

To the best of our knowledge, few studies have investigated the stock price performance of block trade targets in China. Kam et al. (2008) find that the stock market reacts favorably when financially distressed non-SOE firms announce mergers and acquisitions with cash payments, while the stock price declines when the control rights of distressed SOEs are transferred to another SOE. Tuan et al. (2007) find that firms targeted by voluntary tender offers show significantly positive stock price reactions during the 31 days preceding the announcement day, while the cumulative abnormal return from the announcement day to the resolution day is significantly negative. Compared with these studies, our research exploits the data gathered after the split-share structure reform, which enables us to investigate the impacts of stock liquidity on the creation of shareholder value.

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