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Firm performance, asset acquisition and the method of controlling rights transfer: Evidence from the Chinese market

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Abstract

The transfer of controlling rights for a Chinese public company is either a free transfer or an agreed sale. We show that good-performing firms are more likely to be transferred to new owners for free while poor-performing firms are more likely to be sold via agreed sales. Furthermore, we find that demands for these poor-performing companies come from new owners who can subsequently engage in profitable asset acquisitions. In addition, firms that are transferred through agreed sales extract higher returns through subsequent asset acquisitions than firms that are tendered through free transfers.

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1. Introduction

The process of converting from a planned economy to a market economy has led China to allow more diversified ownerships and facilitate transfers of corporate controls to other non-State entities. In the past few years, we have witnessed an increasing number of corporate control changes in China. Nie and Tian (2001) report that between 1996 and 2002, there were over 590 cases of controlling rights transfers, and the trend continued to increase. The development of an off-exchange market to assist the sale of State shares or legal person shares to another entity in 1999 also contributed to the increasing number of controlling rights transfers. Green (2004) points out that the major reason for the State and local governments to tender shares is to withdraw from failing enterprises. Another reason is to restructure the State-owned Enterprises (SOEs) and improve their competitiveness in the market place.

Transfer of controlling rights refers to a change in either the large block shareholder or the ultimate owner of a firm. Currently the two approaches of controlling rights transfer in the Chinese market are free transfer and agreed sale (a.k.a. cash transfer). In the case of free transfer, the controlling rights are transferred from one large shareholder to the other for

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free. This occurs most frequently when the State government is the ultimate owner of both the acquirer and the target, and it is therefore a zero-sum game after the restructuring. Although it is less frequent, the free transfer can also take place between two private firms, as long as they have the same ultimate owner. The agreed sale however is more likely to involve non-State companies where they gain control of a listed company through cash transactions[1].

Methods of controlling rights transfer in China differ greatly from those in the developed countries. Many extant theories that explain the incentives and methods of ownership transfer are not applicable to the Chinese market. Berger and Ofek (1996), Kang and Shivdasani (1997), and Denis and Kruse (2000) suggest that firms in the U.S. actively engage in restructuring activities after asset acquisitions, however they have not considered the impact of the newly-acquired assets on firm performance. Cui and Jing (2006) use the data from Chinese market between 1999 and 2001 and propose a logistic model to forecast the likelihood of controlling rights transfer; Zhi and Tong (2005) examine the relationship between independent directors and controlling rights transfer; Xu, Chen, and Xin (2005) show a general positive market reaction to controlling rights transfer. However, none of these studies examines the subsequent asset acquisitions post the transfer. One of the contributions of this paper is to consider the restructuring activities after controlling rights transfer in China. In addition, we are able to separate the contributions of newly-acquired assets and analyze their impact on firm performance.

We empirically examine the motivations for different types of controlling rights transfer (CRT). We demonstrate that target firms in free transfers are often firms with good performance while target firms in agreed sales are often firms in dire conditions. Furthermore, we show that subsequent asset acquisitions by acquirers are highly correlated with the methods of controlling rights transfer. Specifically, poor-performing companies are often acquired by new owners who can subsequently undertake profitable asset acquisitions.

This paper is structured as follows. After discussing the institutional background, Section 3 presents two hypotheses. Section 4 describes our sample and Section 5 presents our empirical tests and results. Finally, Section 6 offers the concluding remarks.

2. Background

2.1. Listing on the Chinese Stock Exchanges

The Chinese Stock Market was instituted in 1990 with the opening of the Shanghai Stock Exchange. A year later, the Shenzhen Stock Exchange was established to expedite the economic reform. Prior to 1996, the listing requirements were set forth by the Security Committee of the State Council. The Committee set quotas on the number and dollar amount of new issues. Based on the pre-determined quota, local authorities performed the initial screening of companies seeking listing qualifications and then submitted them to the State authorities for final approvals. Frequently, large SOEs had the most preferential treatments and could obtain the listing qualifications easily. In 1996, the State Council passed a decision and demanded both local and State authorities to facilitate the securitization of large and mid-size SOEs. Indirectly, the favorable policies applied to SOEs made it more difficult for an average company in China to gain the listing qualification.

The conditions improved to some extent in 2001, when the State government abolished the quota system. However, another new regulation that took place in 2001 limited the number of underwriting a security company could conduct every year. The largest security company could undertake no more than eight new issues every year, and the number was lower for other security companies. Furthermore, security companies were prohibited from underwriting multiple issues at any given time. Although the intention of the above policies was to enhance the quality of listed companies, it also greatly reduced the competition faced by SOEs when raising external capital. Overall, the listing qualification remained to be a scarce resource in China. Until 2005, there were only 1381 publicly-traded firms in China[2]. Basically, the road to becoming a public company is full of obstacles in China and it is especially true for an average company without any administrative support from the government.

The situation was further exacerbated when the Chinese Security Regulatory Commission (CSRC) implemented a *special treatment* (ST) system to monitor and regulate all listed companies in 1998.[3] If a company failed to earn profits

[1] The agreed sale may also take place between two State companies if they are governed by two independent agencies.

[2] It includes firms issuing either A or B shares. The data is from China Security Regulatory Commission. http://www.csrc.gov.cn.

[3] For more detailed discussions on the *Special Treatment* System, see Bai, Liu, and Song (2002).