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Share reform and the performance of China's listed companies

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Abstract

In 2005, a reform program was initiated in China's stock markets. It acted to increase the proportion of shares that were freely tradable in the markets and also paved the way for a decline in government ownership of listed companies. This paper considers the impact the reform program might have on the performance of listed companies by analyzing the impact the tradable share proportion and the government-owned share proportion had on firm performance immediately prior to the reform commencing. The government-owned share proportion is found to have exerted a linear and positive impact on firm performance. It is further revealed that this impact is best explained by the high ownership concentration of these holdings. The policy implication is that efforts must be made to raise the involvement of non-government institutional investors, including foreign ones, if the reforms are to have their intended effect.

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1. Introduction

The period 2001–2005 was a dismal period for China's stock markets. Despite the macro-economy performing strongly and emerging markets booming globally, the benchmark Shanghai Stock Exchange Composite Index (SHCI) fell by more than one half. A common explanation for this slump relates to the existence of non-tradable shares, a peculiarity of the Chinese markets that until recently saw only around one-third of the shares in listed companies being legally tradable in the market. Nearly all of China's listed companies are ex-state-owned enterprises (SOEs) in which the government has been unwilling to give up a controlling stake during the listing process. At the time of conversion to a shareholding enterprise, various share ownership types were created; amongst them state shares, legal person shares and A shares were the most prominent. State and legal person shares had several commonalities. Firstly, unlike A

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shares, they were not legally tradable. Secondly, also unlike A shares, they were usually government owned. This was exclusively so with respect to state shares. Legal person shares, on the other hand, were held by domestic institutions such as other stock companies, state-private mixed enterprises and non-bank financial institutions (Qi et al., 2000). In a dataset assembled by Delios and Wu (2005), which consisted of listed companies over the period 1991–2001, government-related institutions owned 81.5% of total legal person shares. Thirdly, state and legal person shares comprised a majority of shares in most companies. In the dataset assembled for this paper, which covers firms listed on the Shanghai Stock Exchange at year-end 2004, state and legal person shares accounted for 60% of total shares in an average company. Finally, the ownership of state and legal person shares was highly concentrated. In our dataset, the top five shareholders accounted for 60% of total shares in an average company, compared with just 2.5% for the top five A shareholders.

The existence of state and legal person shares came to be viewed as problematic for several reasons. The first relates to their government ownership. As discussed by Shleifer (1998), relative to private ownership, government ownership of firms can result in all sorts of inefficiencies such as a lack of incentive to minimize cost, and perhaps more importantly, it can blunt the incentives the firm has to innovate. Moreover, government ownership might complicate the usual principal–agent problem by introducing a multiple-principal problem as government owners could pursue objectives (e.g., maintaining employment levels) that are in conflict with minority shareholders (e.g., profit maximization). The second relates to their non-tradable status. Given that state and legal person shares comprise a majority of shares in most companies and they are non-tradable, an outside market in corporate control (i.e., takeovers) has been precluded.

These issues triggered the latest round of share reform. In April 2005, the government initiated a program that eliminated the various share ownership types and made all shares legally tradable A shares. By mid-year 2006, this conversion process had been completed by 94% of listed companies (People's Daily, 2006b). The short-term investor response was extremely positive amidst expectations of improved corporate governance and a greater focus being placed on profit maximization.

Notwithstanding the buoyant short-run market reaction, the expected longer-run impact of share reform on the performance of listed companies is less clear. In theory, the impact of the reforms is ambiguous and this acts as a major motivation for the paper. Two related processes have been set in motion. The first is, most obviously, to increase the tradable share proportion. On the one hand, this might indeed better facilitate the development of an outside market in corporate control. On the other hand, since non-tradable shareholders are unable to engage in short-run speculation and their holdings are highly concentrated relative to tradable shareholders, they might also have a stronger incentive and ability to exercise effective corporate governance (Grossman and Hart, 1980). This is of particular relevance in China's markets where trading until now has been dominated by a diffuse group of retail investors (Farrell and Lund, 2006). The second process is that the reforms pave the way for a decline in government ownership of listed companies. This is for several reasons. Firstly, as part of the share conversion process, non-tradable shareholders were required to compensate tradable shareholders for the effective dilution of their holdings. The most commonly adopted approach was to issue them with new shares. As non-tradable shares were overwhelmingly government owned and tradable shares were not, this led to a fall in the government-owned share proportion. Secondly, prior to reform, regulators did on occasions give permission for non-tradable shares to be sold outside the market. On these occasions, non-tradable shares sold at sharp discounts to the going tradable share price (Walter and Howie, 2003). Government owners will now more readily be able to cash in their holdings at a more attractive price. Thirdly, selling their holdings is one of the quickest ways for governments to raise capital (Walter and Howie, 2003). Finally, gradually unloading government-owned shares would be consistent with the overall trend of moving the Chinese economy toward one based on private property rights. On the one hand, a reduction in government ownership may indeed act to alleviate the multiple-principal problem. On the other hand, in China close government ties can provide firms with numerous benefits such as preferential access to production inputs and a smoothing of regulatory processes (Sun et al., 2002).

The other factor motivating the paper is that reforms that act to raise the status of direct capital markets and improve the performance of listed companies are sorely needed in a bank-based financial system that continues to seriously misallocate capital resources. In 2005, China required a gross capital formation rate of 43.3% to achieve real GDP growth of 10.2%. India, meanwhile, achieved similar real GDP growth at 9.2% but required a gross capital formation rate of just 33.4%. By referencing China's financial system against international performance benchmarks, Farrell and Lund (2006) estimate that if the various deficiencies in China's financial system were addressed, including elevating the role played by direct capital markets, GDP could be 13.4% higher than it currently is.