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State equity ownership and firm market performance: evidence from China's newly privatized firms

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Abstract

This research examines the relation between state equity ownership and firm market performance for China's newly privatized firms in 1994 (164 firms), 1995 (175 firms), and 1996 (252 firms). The overall results show that state ownership has a negative effect on firm value. Tobin's Q is convex with respect to state ownership, such that newly privatized firms gained capital and higher market values, with their increased size paying off in terms of stock returns. The effect of international ownership is unpredictable and domestic institutional ownership does not appear to improve performance, possibly because the latter lack proper incentives to positively influence the firm's management. The results further show that firm performance is not an important determinant of state ownership, but rather, firm size and its strategic industry status are the main determinants of the state's equity ownership in China's newly privatized firms.

Keywords: State equity ownership; International ownership; Domestic institutional ownership; Firm market performance

1. Introduction

China's economic reform is in its third decade and shows a great progress because of numerous reform initiatives and measures (see Goodhart and Xu, 1996). One of the most important of these is the share issue privatization (SIP) of medium- to large-size state-

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owned enterprises (SOEs).[2] China essentially institutionalized the privatization of its SOEs with its establishment of the Shanghai Securities Exchange in 1990 and the Shenzhen Securities Exchange in 1991. At year-end 1998, 931 firms had listed shares on these exchanges, with a 1998 capitalization of Chinese renminbi yuan (RY) 5728.6 billion (approximately US$690 billion in 1998 values) and 34 million shareholders.[3] This may be the strongest evidence that the market economy has taken hold in China and that economic reform has reached the point of no return.

However, the majority of China's SOEs are still not privatized, although every indication shows that the Chinese government intends to privatize most of its SOEs. Are there lessons that can be learned from the past 10 years, as China continues the path of economic reform? The answer is unequivocally yes. Several researchers have studied various aspects of share issues and stock markets in China (see Chen, Firth, & Krishnan, 2001; Chen, Kwok, & Rui, 2001; Ma, 1996; Sjoo & Zhang, 2000), but one important aspect of the Chinese privatization program needs further examination—the state equity ownership in the newly privatized firms. For social, political, and economic reasons, the state retains equity ownership in most of the newly privatized firms (the range is from 0% to 88.5% in this study's sample). Two important questions arise. First, what is the effect of state equity ownership on performance of these newly privatized firms? Second, why does the government decide to hold more shares in some firms and less in others when privatizing its SOEs?

This research focuses on providing answers to these relevant and important questions. First, if policymakers have clear answers, they will be better equipped when making decisions regarding future privatization of SOEs. Second, because of the unique approach of the Chinese privatization program,[4] a better understanding of this type of privatization contributes to existing literature. Finance scholars who engage in privatization, ownership and performance, and transitional economy research will find this research particularly relevant.

This paper examines the relation between state equity ownership and firm market performance for China's newly privatized firms in 1994 (164 firms), 1995 (175 firms), and 1996 (252 firms). Two strands of literature are relevant to this study. On the one hand, agency cost theory (Jensen & Meckling, 1976) argues that shareholders are *not indis-*

[2] China's privatization program was first initiated in April 1984 through a State Commission for Restructuring the Economy proposal to allow workers to directly invest capital in collective and small-size SOEs, and to receive dividends (see Ma, 1995, p. 161). In July 1984 the Beijing Tianqiao Department Store was the first stock company established in Communist China. This experiment was extended to medium- and large-size SOEs in October 1984, and about 13,000 SOEs had been converted to stock companies by year-end 1993 (see Ma, 1995). The establishment of Shanghai and Shenzheng Securities Exchanges in 1990 and 1991, respectively, has institutionalized the government's effort and commitment to reform its vast SOE system through privatization. Table 1 presents some summary statistics of firms listed in China's main exchange, the Shanghai Stock Exchange, from 1994 to1996.

[3] Source: China Security Market Yearbook (1999).

[4] The Chinese government took the gradualism approach to privatizing its SOEs, as oppose to the Big Bang approach (privatize all firms at once) by Russia and other Eastern European countries. China first privatized a few firms in the early 1990s to gain experience and then gradually expanded the program to about 1000 firms by the end of 1998.