



# Propping by controlling shareholders, wealth transfer and firm performance: Evidence from Chinese listed companies<sup>☆</sup>

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## ABSTRACT

Propping acts by controlling shareholders are common in Chinese listed firms. In this paper, we use data on related-party transactions of all listed Chinese firms from 2002 to 2008 to investigate the motivation behind controlling shareholders' propping acts and subsequent wealth-transfer behavior and how both affect firm performance. We find that such institutional motivators as the maintenance of shell resources and qualification for refinancing have a significant effect on the propping behavior of controlling shareholders of Chinese listed firms and that such behavior is often followed by more serious tunneling when shareholders are driven by these motivators. Compared with non-state-owned firms, state-owned firms with the motivation to qualify for refinancing exhibit more severe tunneling after engaging in propping behavior. We also find that while propping by controlling shareholders improves a firm's current operating performance, in firms whose controlling shareholders' are motivated by the desire to maintain shell resources or obtain a refinancing qualification their performance declines in the following year because of subsequent tunneling. The results presented in this paper provide us with a better understanding of the relationship between propping and tunneling, controlling shareholders' engagement in both and the consequences of that behavior.

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## 1. Introduction

Controlling shareholders' expropriation of minority shareholders in listed firms has caused widespread concern in academic circles. Numerous studies show that controlling shareholders often profit from minority shareholders through related-party transactions, particularly in emerging economies with poor protection of minority shareholders. For example, La Porta et al. (1997, 1998, 1999, 2000), Johnson et al. (2000), Glaeser et al. (2001) and Chang (2003) all find that major shareholders are able to profit from minority shareholders through tunneling. Cheung et al. (2006) investigates related-party transactions between companies listed in Hong Kong and their controlling shareholders. They discover that firms that announce these transactions earn significantly lower excess returns than those that do not. They also find that firms listed in Hong Kong with ultimate shareholders in mainland China are more likely to expropriate from minority shareholders through related-party transactions. Controlling shareholders can engage in such expropriation by occupying or shifting funds, by obtaining related-party loans and by selling assets or products below market price to companies with which they enjoy a close relationship. Jiang et al. (2010) finds that controlling shareholders of listed firms tunnel from these firms by means of inter-corporate loans. Zhou et al. (2003) reveal that asset transactions between listed firms and their controlling shareholders are accompanied by transfers of wealth, with the asset revaluation rate of these transactions often higher than that between the firms and their minority shareholders. Li et al. (2005) report that tunneling operations also exist in mergers and acquisitions (M&A) in China. Chen et al. (2003) investigate controlling shareholders' actions against minority shareholders and find that a high-dividend policy serves as a tool allowing these shareholders to shift resources from listed firms rather than increase firm value.

In reality, however, controlling shareholders do not always carry out related-party transactions to expropriate wealth from minority shareholders. Propping is also common in listed firms in China. Controlling shareholders sometimes "prop up" the firms they control for some specific purpose. For instance, Air China, China Southern Airlines and China Eastern Airlines collectively lost RMB27.8 billion in 2008 after engaging in unsuccessful hedging exercises. To ease the financial distress of these firms, their controlling shareholder, the State-owned Assets Supervision and Administration Co. (SASAC), provided them with an instant capital injection.<sup>1</sup> In the same year, Central Huijin Investment Ltd. injected funds into three major state-owned banks to satisfy their need for capital to better support listed companies. In 2009, after ST Zhangjiajie (000430) had a financial deficit for two consecutive years and investors had been warned of its delisting risk, the firm's controlling shareholder issued a written announcement promising to provide funding in the following year. By means of M&As, related-party transactions and equity selling, the controlling shareholder of ST Zhujiang (000505) successfully helped the firm to escape delisting, putting on a show of uncapping, capping and uncapping again.<sup>2</sup>

Controlling shareholders most commonly prop up their listed firms when the firms are facing financial distress or are in need of funding.<sup>3</sup> The means by which they engage in such propping actions are capital injections, loan guarantees, related-party transactions and other types of profit transfers that are in the opposite direction to tunneling operations. Intuitively, the entire process is not only harmless to minority shareholders but may even promote their well-being.

Tunneling and propping are the two major behavioral patterns exhibited by controlling shareholders in conducting related-party transactions. The two opposing patterns may be found in the same company at dif-

<sup>1</sup> The majority shareholders of listed firms tend to support these firms in the face of financial distress. A case in point is China Eastern Airlines, which suffered tremendous losses in 2008 because of the failure of its aviation fuel hedging. The company's losses were so huge that its total debt exceeded its total assets. On April 17, 2009, the firm was tagged for special treatment (ST). Its controlling shareholder, the SASAC, injected 3 billion RMB and 4 billion RMB in capital in November 2008 and December 2009, respectively, thus saving the company from a severe crisis. The cases of China Southern Airlines and Air China are similar.

<sup>2</sup> The capping-uncapping-capping phenomenon is not uncommon among Chinese listed firms. \*ST Zhujiang was saved from being delisted three times and was at risk of delisting in 2001, earning it the nickname "the firm best at fooling."

<sup>3</sup> Friedman et al. (2003) find that in 1997 when the Asian financial crisis hit, controlling shareholders of listed firms in many emerging Asian markets provided funding, loan guarantees, capital injections and other forms of support to the firms they controlled if those firms were faced with financial distress.

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