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Financing decisions after partial privatization in China: Can a stock market quotation really provide discipline?

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ABSTRACT

This paper uses the framework developed by Helwege and Liang (1996) to investigate the post-listing financing decisions of 221 Chinese state-owned enterprises that were partially privatized via the stock market in 1994–1999. First, we estimate a logit panel data model to examine the decision to raise external funds, either bank loans or equity. Our results show that the probability of raising external finance is positively correlated with the firm's cash shortage, but only if non-cash working capital is included in the definition of the deficit. In contrast, firms with a cash surplus are less likely to tap external financial markets. Second, we examine the type of security issued and find that default risk negatively affects the probability of completing a stock offering, while firm-level information asymmetries are not significant. Overall, we document some important differences between the firms where the government retained its majority stake and those where it relinquished it; we link these to differences in the firms' governance and access to financial markets.

1. Introduction

In the case of China, the IPO market has been largely dominated by state-owned enterprises (SOEs) that have undertaken a share issuing privatization (SIP).[1] The basic idea behind these SIPs, it has been

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[1] It was not until 2000 that private enterprises started to float their shares on a more regular basis. Not surprisingly, partially privatized SOEs still account for a very large proportion of listed firms in Mainland China (Huyghebaert and Quan, 2009).

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claimed, was to subject the corresponding SOEs to the discipline of the stock market, as share prices henceforth would reflect information on managerial decisions and firm performance. Examining the validity of this argument is interesting, as the risk of protracted political influence is non-trivial in Chinese listed SOEs. The government has indeed retained a majority stake in many of these firms, reducing its ownership stake only partially at SIP-time by allowing SOEs to sell primary, i.e. newly issued, shares to Chinese domestic investors in the A share market.[2]

Prior research has investigated the influence of stock market quotation on the financial and operating performance of Chinese SOEs, concluding that, unlike other countries, SIPs in China have had a detrimental effect on firm performance (e.g., Sun and Tong, 2003; Wei et al., 2005; Jiang et al., 2009). The underlying reasons for this decline in performance remain unsettled to date. Yet, on average performance deterioration was less pronounced when the government relinquished its majority stake, thereby suggesting that more was going on than just an increased exposure to industry competition forcing SOE profit margins down over time. In this paper, we wish to gain more insights into the question whether a stock market quotation by itself can perform such a disciplining function, by examining whether economic forces became a fundamental driving force of the post-listing financing decisions of Chinese SOEs. We examine this research question for a sample of 221 Chinese SOEs after their listing on the Shanghai stock exchange in the period 1994–1999. A methodological contribution of our article is that we examine *incremental* financing choices in the first five years after SIP. Studying incremental financial decisions rather than capital structure, i.e. the cumulative cross-sectional outcome of prior financing choices, is instructive as the overall debt ratio of listed SOEs does not fluctuate much over time and so conceals the huge number of transactions in debt as well as in equity markets. For this purpose, we use the framework developed by Helwege and Liang (1996). As such, we first analyze what firm-specific financial factors drive the decision to raise external finance, whether in the form of bank debt or equity. Next, we examine the type of security issued. Our main contribution is that we consider the possibility that these two distinctive aspects of post-SIP financing decisions may be influenced by differences in ownership structure across partially privatized SOEs.

First, we investigate whether the decision to raise additional funds after listing is driven by a shortage of cash to finance investment projects, as is implied by the pecking order theory of capital structure (see, for example, Helwege and Liang, 1996; Shyam-Sunder and Myers, 1999; Franks and Goyal, 2003). This research question is worthwhile to explore, as the size of the primary offering in Chinese SIPs during the 1990s was not determined by the need to finance investment outlays (see Sun and Tong, 2003; Bai et al., 2004; Huyghebaert and Quan, 2009). Instead, SOEs that relied heavily on state financing through loans from state-owned banks, through trade credit from other SOEs, and/or through subsidies, raised more equity at their SIP. Taking these firm-level financing decisions at the occasion of the SIP as our control group, we evaluate the effect of stock market quotation. Conversely, listed SOEs in which the Chinese state remained a dominant owner after SIP may have continued to pursue political objectives, such as offering low prices to consumers, guaranteeing employment, etc. Such expropriation of minority investors could be accomplished rather easily, as property rights are poorly protected in China (Cull and Xu, 2003, 2005; Allen et al., 2005; Li et al., 2008). Nonetheless, realizing political goals is expensive and, thus, may cause a shortage of cash from operations for the listed SOEs that pursue them. The latter firms could now also use their stock market access to raise extra funds in order to meet their extensive financial obligations from business operations. If this scenario arises, it is likely to apply especially to the partially privatized SOEs in which the State retained its majority stake after SIP.

Second, given the decision to access external financial markets, we examine the subsequent choice between borrowing from banks and issuing new shares. Corporate bonds were not a viable financing alternative during our sample period. In general, two categories of firm characteristics can explain the security choice. While we agree that information asymmetries between firms and investors over the value of the firm should lead to a preference for debt over equity in the case of partially privatized SOEs, as is implied by the models developed by Myers (1984) and Myers and Majluf (1984), we further contend that variables capturing the firm's default risk may be negatively associated with the probability of share

[2] In this paper, we use the term 'government' in a general meaning, including the central as well as the various local governments with the power to make strategic decisions in the firm.