



Buy high, sell low: How listed firms price asset transfers in related party transactions

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ABSTRACT

We examine a sample of 254 related party and arms' length acquisitions and sales of assets in Hong Kong during 1998–2000. Our analysis shows that publicly listed firms enter deals with related parties at unfavourable prices compared to similar arms' length deals. Firms acquire assets from related parties by paying a higher price compared to similar arms' length deals. In contrast, when they sell assets to related parties, they receive a lower price than in similar arms' length deals. With the exception of audit committees, corporate governance characteristics have limited impact on transaction prices. Firms with audit committees on their boards pay lower prices to related parties for acquisitions and receive higher prices from related parties from divestments.

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1. Introduction

What is the process through which controlling shareholders extract resources from publicly listed companies that they control? Most of the academic literature on tunneling has attempted to measure expropriation using indirect proxies for the propensity of firms to expropriate (see for example, Bertrand et al., 2002; La Porta et al., 2000a, 2002; Faccio et al., 2001). These papers do not identify specific channels through which tunneling might occur.

A second stream of literature examines the market reaction experienced by the publicly listed firm when they announce different types of related party transactions (see for example, Cheung et al., 2006; Baek et al., 2006; Bae et al., 2002). These studies show that the shareholders of publicly listed firms that are subject to tunneling experience a reduction in firm value. They assume that investors are able to accurately predict the implication of the related party transaction for the value of the public firm. It is however unclear that the reduction in firm value is entirely due to the related party transaction. For example, suppose investors cannot accurately predict the impact of the related party transaction to the value of the public firm. Instead, they perceive it as a signal

of bad corporate governance, and mark down the values of *all* companies that engage in such transactions. A recent article in the *Wall Street Journal* titled "Even good insider deals raise doubts" commented

"... Such related party transactions raise questions about whether corporate insiders are fully focused on the interests of shareholders, experts say. The deals, no matter how small, can create the impression that an insider is using company assets for personal benefit, and that the company is getting the short end of the stick. ..."¹

Cheung et al. (2006) show that firms that conduct value-destroying related party transactions continue to decline in value for up to 12 months following the transaction, suggesting that investors penalize these firms for much more than the information contained in the related party transaction announcement. It is therefore an open question exactly how related party transactions serve as channels through which expropriation might occur.

In this paper, we attempt to answer this question by comparing the *price* at which controlling shareholders conduct asset transfers with the companies they control in related party transactions with the *fair value* of the assets, in a sample of 140 asset acquisitions (78

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¹ "Even good insider deals raise doubts", *Wall Street Journal* (May 7, 2003), page B6.

from related parties and 62 from arms' length non-related third parties) and 114 asset sales (51 to related parties and 63 to arms' length third parties) by Hong Kong publicly listed firms during 1998–2000.

Our main variable of interest is the difference between the transaction price and the “fair” value of the assets changing hands. Since the traded assets in the related party and the arms' length transactions in our sample are not public companies, they have no observable market value. Hence our analysis draws on research which suggests that earnings and book values serve as important determinants of the economic value of a firm's assets (Copeland et al., 2000; Ohlson, 1995; Collins et al., 1997). Specifically, we use a methodology which assumes that the fair value of the assets to the buyer or seller can be estimated as a function of the accounting book value and past operating earnings of these assets.

After controlling for the operating performance and the industrial classification of the traded assets, we show that publicly listed firms sell assets to their controlling shareholders at a *discount* relative to the price of similar arms' length (non-related) transactions. At the same time, publicly listed firms acquire assets from their controlling shareholders at a *premium* relative to the price in similar arms' length transactions. In other words, controlling shareholders appear to benefit directly at the expense of publicly listed firms by selling assets to them at above market prices and by acquiring assets from them at below market prices. Corporate governance variables have limited impact on the pricing of the deal. Only firms with an audit committee on their board and firms with a large analyst following conclude related party transactions at more favourable prices. We find no support for an alternative hypothesis that these transactions are driven by tax management considerations rather than expropriation.

Prior papers on specific mechanisms, such as related party transactions, through which tunneling occurs have focused on the pricing of loans obtained by related parties. We extend this literature by analyzing how tunneling occurs in other types of related party transactions, such as asset acquisitions or sales. The Hong Kong market is appropriate for conducting this research because it is dominated by firms with concentrated ownership, providing us with a large representative sample of related party asset transfers. In addition, disclosure of detailed information about related party transactions is mandated in the listing rules of the exchange.

The remaining of the paper is organized as follows: The next section briefly reviews the literature on tunneling. Section 3 describes the data. Section 4 describes our valuation methodology. Section 5 reports our empirical results. Finally, Section 6 discusses our conclusions.

2. Survey of the literature on tunneling

The problem of tunneling is of particular significance in companies with concentrated ownership, because controlling shareholders have the power to expropriate minority shareholders. Such ownership structures are very common in many countries around the world and particularly in East Asia (La Porta et al., 1999; Claessens et al., 2000).²

The theoretical literature on tunneling is relatively limited compared to the empirical literature. Its origins lie in the literature of optimal security design, which recognized the existence of private benefits of control (see for example Harris and Raviv, 1988). More recent theoretical studies have modelled tunneling and propping directly. Friedman et al. (2003) develop a model where controlling

shareholders of firms take on debt as a pledge to prop up the firm (negative tunneling) in adverse economic conditions. Shleifer and Wolfenzon (2002) develop a model in which entrepreneurs set up companies in an environment with limited legal protection of outside investors where tunneling is possible. They use the model to derive implications about the relationship between investor protection and the size and development of stock markets.

Other models use tunneling and propping as ingredients in models that justify the establishment of business groups as pyramids. Riyanto and Toolsema (2008) develop a model where outside shareholders of firms down the pyramid trade off the potential costs of tunneling by the controlling shareholders against the potential benefits from propping. Almeida and Wolfenzon (2005) show that the pyramidal structure is optimal when potential diversion of private benefits of control by controlling shareholders increases the discount that outside investors pay for the shares of a new firm, and hence obliges controlling shareholders of an existing firm to use internally generated funds to set up the new company.³

In general, the theoretical literature on tunneling models tunneling as a diversion of company cash flows or retained earnings to the controlling shareholder's pockets.

Most prior empirical research has attempted to measure the expropriation of minority shareholders indirectly, using different proxies for the degree of expropriation. These studies do not examine the channels through which expropriation might occur nor do they measure whether the value of minority shareholdings declines following specific corporate actions. Some studies use the legal system (in particular investor protection) as a proxy for the likelihood of expropriation (La Porta et al., 1998, 2000b; Johnson et al., 2000; Nenova, 2003; Djankov et al., 2008). The legal system has been shown to affect dividend policy (La Porta et al., 2000a), firm valuation (La Porta et al., 2002), stock liquidity (Brockman and Chung, 2003; Chung, 2006), and bidder gains in mergers (Hagendorff et al., 2008).⁴ Other studies use the deviation of cash flow from control rights as a proxy for the likelihood of expropriation. This measure has been shown to affect dividend policy (Faccio et al., 2001), firm valuation (Claessens et al., 2002; Lemmon and Lins, 2003; Baek et al., 2004; Maury and Pajuste, 2004), firm profitability (Joh, 2003), analyst following (Boubaker and Labégorre, 2008), and how earnings shocks propagate from group firms where the controlling shareholders have low cash flow rights to firms where they hold high cash flow rights (Bertrand et al., 2002).

More recent empirical literature examines specific channels through which expropriation could be manifested, for example, extending loan guarantees to related parties (Berkman et al., 2008), related party transactions between publicly listed firms and their controlling shareholders or directors (Cheung et al., 2006; Gordon et al., 2004; Kohlbeck and Mayhew, 2004), private securities offerings by industrial groups (Baek et al., 2006), and rescue mergers within industrial groups (Bae et al., 2002).⁵

However, these studies are silent on exactly how these transactions reduce firm value. A few papers have examined the benefits obtained by controlling shareholders in related party deals. These

³ In a different type of model, Atanasov et al. (2008) provide a taxonomy of tunneling actions and develop a simple model of how these actions affect stock prices and financial metrics.

⁴ The relationship between the legal system and potential expropriation is significant because even a small chance of being prosecuted can affect the behavior of controlling shareholders. For example, even in a country characterized by poor legal protection of investors such as China, the extent of controlling-minority shareholder conflicts (measured among other proxies by the extent of use of related party transactions) has been shown to affect the demand for purchasing director and officer liability insurance (Zou et al., 2008).

⁵ Although other studies have found that equity transfers between firms belonging to the same industrial group (Buysschaert et al., 2002), and acquisitions by group affiliated firms (Faccio and Stolin, 2006; Holmen and Knopf, 2004) do not destroy firm value.

² For an extensive survey of the corporate governance literature, see Shleifer and Vishny (1997). For a survey of the international literature, see Denis and McConnell (2003). For a survey with particular emphasis on Asia, see Claessens and Fan (2002).

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