Pacific-Basin Finance Journal 17 (2009) 372–393

Contents lists available at ScienceDirect

Pacific-Basin Finance Journal

journal homepage: www.elsevier.com/locate/pacfin

Tunneling and propping up: An analysis of related party transactions by Chinese listed companies ☆

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A R T I C L E   I N F O

Article history:
Received 13 March 2008
Accepted 19 October 2008
Available online 5 November 2008

JEL classification:
G15
G34
K33

Keywords:
International corporate governance
China
Related party transactions
Tunneling
Propping

A B S T R A C T

We examine a sample of related party transactions between Chinese publicly listed firms and their controlling shareholders during 2001–2002. Minority shareholders in these firms seem to be subject to expropriation through tunneling but also gain from propping up. On balance, there seems to be more tunneling than propping up. Both types of firms have larger state ownership compared to the rest of the Chinese market but firms that are propped up are larger and have larger state ownership than firms subject to tunneling. Propped up firms are more likely to have foreign shareholders and to be cross-listed abroad compared to firms that are subject to tunneling. Propped up firms also tend to have worse operating performance in the fiscal year preceding the announcement of the related party transaction. Finally, we find that related party transactions representing tunneling are accompanied by significantly less information disclosure compared to related party transactions representing propping.

1. Introduction

The vast majority of the academic literature on the expropriation of minority shareholders by controlling shareholders has examined indirect proxies for the likelihood of expropriation.[1] There are relatively few papers that examine direct avenues through which expropriation may occur.

☆ We would like to thank Jun-Koo Kang (the editor) and an anonymous referee for suggestions that significantly improved the paper. We also thank Helen Tse, Anita Wong, Lingling Wu, and Lynda Zhou for research assistance.
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[1] See, for example, Bertrand et al. (2002), La Porta et al. (2000a, 2002), Claessens et al. (2002), or Faccio et al. (2001).

0927-538X/$ – see front matter
doi:10.1016/j.pacfin.2008.10.001

In this paper, we examine the incidence, characteristics, and valuation consequences of a sample of related party transactions between publicly listed firms and their controlling shareholders in China. We use these transactions to identify the potential for both tunneling and propping up activities by the controlling shareholder. Djankov et al. (2008) note that related party transactions may provide direct opportunities for related parties to extract cash from listed companies through tunneling activities. For example, in April 2001, Tianjin Beacon Paint & Coatings Co. Ltd., a state-owned company controlled by the local government of the city of Tianjin and listed on the stock exchange of Shenzhen, transferred the equivalent of US$4 million in cash to its non-listed state-owned controlling shareholder for safekeeping and management, in a transaction that breached the exchange's listing rules. The market reacted by marking down the stock price of Tianjin Beacon by −3.4% (after adjusting for general market movements) during the five day window around the announcement of the related party transaction.

However, as Friedman et al. (2003) note, related party transactions can also be used to prop up under-performing firms. In a typical example, in August 2001, Luoyang Glass Co. Ltd., another state-owned firm controlled by the local government of the province of Henan and listed on the stock exchange of Shanghai, received a US$28 million loan and bank loan guarantee from its non-listed state-owned parent. Luoyang Glass was an under-performing company whose return on equity (ROE) and market-to-book ratio were below the industry median, while its debt-to-equity ratio was above the industry median. The market reacted by marking up the stock price of Luoyang Glass by 8.1% (after adjusting for general market movements) during the five day window around the announcement of the related party transaction.

Finally, related party transactions may also be motivated by purely economic reasons (for example, to re-align the firm's operations). In these cases, the valuation effects of related party transactions would not be expected to be different from the valuation effects of similar arms' length transactions conducted with non-related third parties.

In general, prior academic research has focused much more on tunneling than on propping. Identifying the potential for tunneling or propping transactions is an important topic. Though China is emerging as a significant economic power, little research is available on the determinants of performance for firms in a state-controlled economy. Using purchasing power parity exchange rates, the Chinese economy is the second largest in the world, and at current growth rates, it may become the largest in less than 10 years (Allen et al., 2005). The combined market turnover of the two Chinese stock exchanges would make them the second largest in Asia, following Tokyo and ahead of Hong Kong. Increasing numbers of Chinese firms are cross-listed in Hong Kong and in the U.S., and many international investors buy shares in these companies in order to participate in the spectacular growth of the Chinese economy.

In our analysis, we examine a sample of 292 related party transactions between Chinese publicly listed firms and their controlling shareholders obtained from filings submitted to stock exchange authorities during 2001–2002. Using filings to the stock exchange as our source of data for related party transactions as opposed to an online dataset such as the China Stock Market and Accounting Research (CSMAR), has both advantages and disadvantages. Reading the filings allows us to observe the entire set of information about the related party transactions that firms make public. It thus allows us to evaluate how extensive the information disclosure is. As we show later on, we document significant differences in the information disclosure between tunneling and propping up related party transactions. We also find significant differences between the information disclosure in the Chinese market and that in the neighboring Hong Kong market. However, since our sample is hand collected, we have to limit the sample period to two years in order to make the task of locating, collecting, and reading hundreds of filings manageable. Time considerations for collecting and processing the filings limit our ability to extend the sample to many years. For this study, we chose our sample period to coincide as much as possible with the Hong Kong data used by Cheung et al. (2006), in order to make comparisons between related party transactions in Hong Kong and China. Nevertheless, as we discuss later, we do not expect that limiting our sample period biases our results.

In the first part of our analysis, we examine the characteristics of firms that conduct different types of related party transactions and the characteristics of the transactions undertaken. On balance, there seems to be more tunneling than propping up in our sample. While both types of firms have larger state ownership than the rest of the Chinese market, firms that are being propped up are larger than firms subject to tunneling. Propped up firms are also more likely to have foreign shareholders (B-shares available to foreign investors in the Chinese stock markets), and to be cross-listed abroad (H-shares available to Hong