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Having the wrong friends at the wrong time: Effects of political turmoil on politically-connected firms

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ABSTRACT

We examine effects of political turmoil on equity return, risk, and corporate governance of politically-connected firms in Egypt. Political strife leads to shifts in the balance of power among different factions. Our analysis shows that equity risk of firms connected to fractions encountering intense political rivalry and public discontent rose, without any compensating increase in return. Political tie that is neutral to regime changes exhibits lower risk. By examining agency-cost measures in different regimes, we find that political instability may exert disciplinary effects on connected shareholders' behavior. In our sample, expropriation in the connected firms became subdued during Egypt's unrest.

1. Introduction

Previous studies have established a set of correlations between political connection and firm value, risk, and some aspects of corporate governance. Common findings suggest that political connection enhances firm valuation (Faccio and Parsley, 2009; Faccio, 2006; Fisman, 2001; Roberts, 1990); but part of the increase in equity return reflects the firms' increased exposure to policy risk (Kim et al., 2012; Pantzalis and Park, 2014); and politically-connected major shareholders expropriate minor shareholders more than the non-connected counterparts do (Berkman et al., 2010; Chen et al., 2011; Cheung et al., 2005). The literature also documents a variety of strategies adopted by firms around the world to build political assets, such as making donations to political campaigns, having the business owners themselves seek public office, or adding politicians to the board of directors (Bunkanwanicha and Wiwattanakantang, 2009; Goldman et al., 2009; among others). All of these studies use data sampled from politically stable times.

Political environment, however, can substantially change the effects of political connection. In a sample of Chinese firms, Cumming et al. (2016) find that political instability would affect the impact of preferential loan access enjoyed by politically connected firms. Jackowicz et al. (2014) find that when political environment became relatively stable in Poland, the negative impact of political ties on operational performance decreases. Siegel (2007) argues that tie to a social-political network rivalling the regime in power can be a liability instead of an asset. Similarly, connection to the political incumbent can also become a liability if there is severe public discontent towards the government or the ruling party. In recent years, protracted political instability involving intense power struggle or mass protests have been observed with increasing frequency, such as the Arab Spring (2011–2012), repeated color-shirt protests leading to a military coup in Thailand (2006, 2008–2010, 2013–2014), and uprising in Ukraine in 2014. Yet, very few empirical studies have examined the downsides of political connection in such an environment. In this paper, using a sample of listed

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Egyptian firms over the period of 2009–2014, we focus on the effects of political turmoil on connected firms' frequently-examined characteristics to highlight the difference from the results found in the literature.

Since we compare financial characteristics of connected firms between a turmoil and a stable time, a key challenge is to distinguish the impact of political instability on business performance of all firms from the adversity encountered by those having connection to a specific political faction. Egypt's upheaval of 2011–2014, a natural experiment in that multiple regime changes were exogenous to Egyptian firms, provides a suitable platform because the target of protest and political rivalry varied in these regimes. We also examine data based on 2009–2010, when there was still stability in Egypt, as a benchmark for comparison; results based on this "normal" time are consistent with findings in previous studies.

Our paper contributes to the literature, including Acemoglu et al. (2017), by offering the following new insights: First, political connection, even to the incumbent, can turn into a liability during a political turmoil. Our analysis shows that equity returns of Egyptian firms connected to factions facing intense political rivalry and public discontent, regardless of whether that faction was the incumbent, were lower than those of non-connected firms. Since our interest is to examine the effects of variation in political rivalry and target of public protest across multiple regimes in a turmoil, we measure firm equity returns over the whole length of each regime because they better represent how the balance of power shifts in each regime. Acemoglu et al. (2017), on the other hand, examine impact of episodic street protests on firms' stock return surrounding those protests. As the intensity of the protests only influences the *probability* of the collapse of that regime, stock returns surrounding individual events within a regime cannot fully capture the effects of the regime change and, consequently, the effects of political connection on firms. Moreover, within each regime, "bad" news such as intense protests and "good" news such as crackdowns on protest can have offsetting effects on the tenure of the political incumbent and therefore on connected firms' characteristics.

Besides equity returns, we examine equity risks, measured in terms of volatility of stock prices in each regime. Stock price of firms connected to factions embroiled in political rivalry displayed greater volatility without any compensating increase in return; on the other hand, firms with state ownership, a political asset that is neutral to regime changes, exhibited lower equity risk without any drop in return.

Second, by analyzing agency cost measures across different regimes, we find that political instability may exert disciplinary effects on connected shareholders' behavior. Although Acemoglu et al. (2017) *interpret* negative correlation between the intensity of episodic street protests and stock returns of firms connected to the incumbent as evidence of popular mobilization and protests playing a role in constraining *future rent seeking*, they do not explicitly analyze agency-cost measures to support this interpretation. Our analysis, on the other hand, explicitly demonstrates that expropriation in the connected firms became subdued during Egypt's unrest, probably because of pressure from public scrutiny and expectation of better investor protection and corruption control. To check whether the extent of expropriation was reduced by political unrest or by worsening business environment, we also examine how political connection affects the same agency cost indicators in 2009, the year Egypt recorded decade-low economic growth owing to the global financial crisis; there is clear and robust evidence of expropriation in connected firms at that time.

Our results have important implications for business owners, finance professionals, and political scientists. Although business owners seeking connection to political power is not a new and rare phenomenon, the possibility that connections may turn into liability under some conditions has not been properly explored. In a recent review focusing on emerging economies, Claessens and Yurtoglu (2013) note that there are many unknowns regarding the channels which political economy factors affect corporate governance. This study thus serves to provide some insights for political science studies on how political atmosphere may shape the incentive and behavior of connected shareholders.

The remainder of the paper is organized as follows. In Section 2, we discuss the potential downsides of political connection in a turmoil and describe the political landscape in Egypt during 2010–2014. Section 3 describes the data sample and methodology. Section 4 presents our results. We offer some concluding remarks in Section 5.

2. The downsides of political connection in a political turmoil

2.1. Potential impact of political rivalry and public resentment on connected firms

Gulati and Higgins (2003), Gulati and Westphal (1999), and Labianca and Brass (2006) suggest that value of social networks varies with environmental conditions, and social networks that cause distrust or rivalry relationship for firms would adversely affect their business prospect. In the context of political networks, anecdotal examples of how firms suffer from political connection abound in emerging countries. For example, there was a backlash against connected firms and political pressure to dissolve Salim Group after Suharto lost power in Indonesia (Dieleman and Boddewyn, 2012). In Thailand, after Thaksin was dislodged from power by a military coup and anti-corruption probes were set up against him and his associates, some members quit Thaksin's Thai Rak Thai party to distance themselves from him. As noted by Siegel (2007), "when a firm has a network tie to the political enemies of those currently holding power, that firm can be the victim of retribution and direct government effort at exclusion." Thus, it is reasonable to surmise that, under some conditions, political connection can become a liability, just as in the case of social networks.

Most studies, however, focus on how positive value of political connection changes under different political events.[1] Siegel (2007) is the only study that explicitly investigates negative value of political connection. Using a sample of South Korean firms, he finds that

[1] For example, in a pioneering study, Fisman (2001) shows that stock price of firms connected to Suharto were negatively correlated with rumours of declines in his health, and this correlation reflects positive value of the connection.