

Founder Control, Ownership Structure and Firm Value: Evidence from Entrepreneurial Listed Firms in China¹

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Abstract

In emerging markets, the deviation between the ultimate controlling shareholders' voting rights and their cash flow rights (hereafter "DVC") in the listed firms is quite prevalent. DVC could be introduced due to the ultimate controlling shareholders' opportunistic incentives, as well as by their incentives to improve firm efficiency. This study uses 229 listed firms ultimately controlled by individuals or families (hereafter "entrepreneurial firms") for 2004 in China, to investigate the effect of DVC on firm value and to determine whether it is different between founder and non-founder controlled firms. We find that DVC has a positive effect on firm value for founder controlled firms. This result implies that investors believe that their interests are better protected by founder controlled firms than by non-founder controlled firms.

Key Words: Founder Control; Ownership Structure; Firm Value, China, Tunneling

Jel Classification: G34, G32

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Introduction

In recent years an increasing number of studies have examined the causes and consequences of corporate ownership structure. A seminal paper by La Porta *et al* (1999) finds that many firms around the world have a concentrated ownership structure and a controlling shareholder, which usually is a family or state agency. Claessens *et al* (2000) examined East Asia, Faccio and Lang (2002) and Barca and Becht (2001) examined Western Europe, Khanna (2000) examined emerging markets, and Morck *et al* (2000) and Attig *et al* (2003) examined Canada. Collectively they find that the controlling family uses a pyramidal ownership structure to control the firms in the business group. Recent research has examined the effect of family control and pyramidal ownership structure on corporate governance (Khanna and Palepu, 2000; Khanna and Rivkin, 2001; Bae *et al*, 2002; Bertrand *et al*, 2002; Claessens *et al*, 2002; Anderson and Reeb, 2003; Anderson *et al*, 2003; Attig *et al*, 2003; Lins, 2003; Lemmon and Lins, 2003; Villalonga and Armit, 2006). The causes of ownership structure, especially the pyramidal structure of family controlled firms have also been examined (Bertrand *et al*, 2005; Almeida and Wolfenzon, 2006). This research has added new theories and evidence about the corporate governance of family controlled firms in various countries. The findings are useful, not only to understand the corporate governance characteristics and behavior of family controlled firms, but also for evaluating corporate governance efficiency.

Since the founding of the Chinese stock market in the early 1990s, listed firms restructured from state-owned enterprises (SOEs) have been the majority of all listed firms. As a result, research on corporate governance issues of firms in China has mainly focused on corporate governance issues of state-controlled listed firms. There is little research on corporate governance issues of entrepreneurial listed firms.³ However, in recent years, the number of entrepreneurial firms has increased notably as the result of reforms in IPO regulations and the privatization of state-controlled listed firms. By the end of 2004, about a quarter of listed firms were entrepreneurial firms (Kong and Zhang, 2005). Subsequently, corporate governance issues of entrepreneurial firms have attracted the attention of researchers. Xia and Fang (2005) find that compared with the non-state-controlled listed firms, state-controlled listed firms, especially those controlled by the county or city level governments have lower firm value, especially in regions with weak institutional environments. Because the major part of the non-state-controlled listed firms are the entrepreneurial listed firms (the remainder are the firms

³ In this paper, state-controlled firms refer to the firms ultimately controlled by the government agencies such as the finance bureau and the state asset supervisory and management committee, and entrepreneurial firms refer to the firms ultimately controlled by individuals or families.

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