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Connected transactions and firm value: Evidence from China-affiliated companies☆

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ABSTRACT

This paper investigates tunneling through related-party transactions (RPT) using a unique dataset of listed Chinese companies in Hong Kong. While prior findings suggest that investors do not seem to systematically discount tunneling firms, we find that firm value (Tobin's q and market-to-book value) is significantly lower for firms undertaking potentially expropriating transactions. In addition, cumulative abnormal returns (CAR) are lower for RPTs with disclosure exemptions and are negatively related to some RPT types. Our results suggest that firms tunnel using RPTs with disclosure exemptions and that disclosure requirements matter for RPTs. These RPTs could signal firms' corporate-governance quality, as investors substantially discount firms that undertake potentially expropriating transactions.

1. Introduction

Earlier studies related to tunneling use indirect proxies to examine potential expropriations (e.g. Bertrand et al., 2002; Bae et al., 2002; Sung, 2003; Friedman et al., 2003). Recent research instead focuses on related party transactions (RPT) as a direct measure of tunneling (e.g. Berkman et al., 2009; Cheung et al., 2009a, 2009b; Jian and Wong, 2010). RPTs become the focus because, as Johnson et al. (2000) suggest, tunneling activities in both developed and emerging markets are mostly legal. It is plausible that the controller may choose not to disclose the firm's expropriating transactions, or may attempt to arrange these transactions to look like normal business deals. Concealing or disguising these transactions, however, usually violates disclosure requirements of listed companies and may increase legal liabilities. Therefore, RPTs may provide a channel to facilitate tunneling

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activities legally. Even though these transactions are legitimate from a legal perspective, investors may still recognize the conflict of interest and potential expropriation. Then, do investors impose a governance discount on firms that engage in RPTs? Do differences in disclosure requirements matter? What types of RPTs facilitate tunneling?

Cheung et al. (2006) analyze 375 connected and discloseable[1] transactions between 1998 and 2000 that required distributing a circular to shareholders and independent shareholders' approval. They compare these transactions with discloseable transactions of similar transaction types and conclude that a negative excess return occurs when these transactions are announced. They also find that China-related firms are more likely to undertake connected and discloseable transactions that are expropriating. Surprisingly, their results suggest that investors do not seem to predict tunneling activities, because firms that undertake expropriating transactions are not traded at a discount. One possible reason for this finding is that their samples of connected transactions (CT) are large-size CTs, which are also discloseable transactions. These transactions are subjected to more stringent disclosure requirements, such as the distribution of circulars and independent shareholders' approval.

Within Hong Kong (HK) institutional settings, insiders can “legalize” tunneling by using smaller CTs, because these CTs are exempt from independent shareholders' approval and the distribution of circulars. Larger CTs (e.g., connected and discloseable transactions), in contrast, require more detailed disclosure, and independent shareholders may intervene in the transactions. This institutional setting provides opportunities for insiders to legalize tunneling. Therefore, we argue that tunneling activities usually go through transactions with disclosure exemptions (CTs *only*). And since undertaking these transactions may signal the firms' intention to minimize disclosure and avoid shareholders', scrutiny, investors will impose a governance discount on these firms.

To address the research questions, we use a unique dataset that includes all CTs with disclosure exemptions, which constitute about 80% of all RPTs.[2] This study focuses on the RPTs of companies listed in the HK stock market. The HK market is an appropriate setting for this study for a few reasons. First, HK has some of the strongest legal protections among all emerging markets, implying that the requirement to disclose CTs is generally enforceable. Second, the listing rules explicitly govern connected and notifiable transactions and are associated with detailed instructions with respect to relevant transactions.[3] Third, there is evidence of tunneling in HK (Cheung et al., 2006). There are two major types of mainland China-related shares: Red Chips[4] and H Shares.[5] We focus on these two types of shares because regulation differences between mainland China and HK may facilitate tunneling activities. Controlling shareholders, which are often Chinese firms, may take advantage of the different legal jurisdictions between HK and China. Cheung et al. (2006) also suggest that mainland China companies are more likely to undertake expropriating CTs. Furthermore, hand-collecting the transaction data concerning the full sample of HK stocks is prohibitively time-consuming.[6] It is appropriate, therefore, to focus on just Red Chips and H Shares.

The major findings in this paper are summarized as follows. For companies that undertake potentially expropriating transactions, Tobin's q and market-to-book value (MTBV) are significantly lower. Even though these RPTs are relatively small in size, the discount on firm value (firms undertaking expropriating transactions have an average 33.4% lower Tobin's q) is much larger than the cumulative abnormal return (CAR) of the related transactions (about −1% to −2% CAR for average CTs). These results suggest that there are systematic discounts on firm value if a firm undertakes RPTs and that controlling insiders usually expropriate through CTs with disclosure exemptions. We find that there are lower CARs for transactions related to Continuing, Contractual Agreement, and Loan and Guarantee. Also, connected and discloseable

[1] A discloseable transaction is defined in the Hong Kong Stock Exchange Listing Rules as “[a] transaction or a series of transactions (aggregated under rules 14.22 and 14.23) by a listed issuer where any percentage ratio is 5% or more but less than 25%.”

[2] The remaining 20% of RPTs are connected and discloseable/major/very substantial/reverse takeover transactions, available in “Hong Kong Listed Companies: Corporate Documents” provided by the HK Stock Exchange. Thus, our dataset is different from that of Cheung et al. (2006).

[3] The details on notifiable transactions are available in Chapter 14 of the HK listing rules.

[4] Red-Chip companies are mainland-controlled companies incorporated outside of mainland China, wherein the largest shareholder holds at least 35% of companies' shares either directly, or indirectly through companies controlling these entities.

[5] H-Share companies are incorporated in mainland China and are approved by the China Securities Regulatory Commission to be listed in HK. The letter H stands for Hong Kong.

[6] The connected-transaction announcements are obtained by opening all announcement files, of which CT announcements are less than 10% of the all types of corporate announcements.