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A Study on the Effect Brought by Different Types of Ownership Control—Based on the Evidence from China's Listed Companies

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Abstract

By tracing the identity of large shareholders, this paper groups China's listed companies into four categories by different controllers and argues that these distinct types of owners have different objectives and motivations. As a result, this will affect how they exercise their control rights over the firms they invest in. In particular, the author contends that private ownership of listed firms in China is not necessarily superior to certain types of state ownership. To test the arguments the author investigates the relative efficiency of state versus private ownership of listed firms and the efficiency of various forms of state ownership. The empirical results indicate that the operating efficiency of Chinese listed companies varies across the type of controlling shareholder and the results are consistent with the predictions in the introduction.

Keywords: State ownership, Private ownership, Large shareholders, Ownership structure

1. Introduction

China's economy has undergone a significant transformation in the past quarter-century. Large swathes of industry have been reorganized as corporations and the profitable operating arms of many state owned enterprises (SOEs) have been privatized and listed on the stock market. Today, there are more than 1500 listed firms and China's market capitalization is the sixth largest in the world. Many companies are becoming world leaders; as one example, and PetroChina was once the largest listed company in the world in terms of market capitalization. In many ways the economic reforms can be regarded as a major success. Annual economic growth has averaged 10% in the past decade, exports have increased many-fold, foreign reserves are the largest in the world, and the marginal productivity of labor has increased substantially. Despite these successes, the profitability of listed firms has been poor (Chen and Firth and Rui, 1998, working paper and Chen and Firth and Rui, 2006a, pp. 82–109) and this raises concerns about firms' sustainability and financial distress.

Some studies have suggested that the state's retained shareholdings in listed firms have been responsible for their poor profitability. However, these studies have shortcomings as they fail to properly identify and distinguish among the different types of owners (Wang, 2003, Ph.D. thesis). In particular, prior research uses share type as a proxy for owner type but we demonstrate that this assumption is not valid and can lead to erroneous conclusions. The aim of this paper is to remedy the shortcomings in prior research by providing an in-depth examination of the relations between ownership structures and firms' performance in China. A key feature of many of China's privatized state owned enterprises is that the state retains a significant ownership stake after listing; in this sense privatized firms are actually partially-privatized. Although the state often retains substantial ownership in listed firms, this ownership is scattered among various agencies and each of these have different motivations and incentive structures. We argue that the different forms of state ownership lead to different performance outcomes for the firms they have invested in. Thus the lumping of all types of state ownership into one group, as has been done in prior studies, obscures the real impact of the state as a shareholder. We also argue that it is imperative to determine who the real share owners are, and what their motives are, rather than rely on the legal definition of shares as a proxy for ownership type.

A distinct characteristic of Chinese listed firms is that they have a single dominant shareholder whose ownership far exceeds that of the second largest shareholder. We classify the dominant shareholder into those that are state owned and those that are private. State ownership of firms is frequently criticized because of political intervention and the need to help achieve government objectives (Boycko and Shleifer and Vishny, 1996, pp. 309–319). These studies implicitly assume there is just one type of state owner. However, in China, the state's ownership of firms is undertaken by different types of agencies and we argue that the objectives of these agency-types dictate the extent of political intervention and the degree of commercialization of the listed companies they invest in. We classify state owners in

China's listed companies into three major types based on their political and economic interests: SAMBs (state asset management bureaus), SOECGs (SOEs affiliated to the central government), and SOELGs (SOEs affiliated to the local government). We argue that these three types of state owners have very different objectives when it comes to the listed firms they control.

We find that SOECG controlled listed firms excel in almost every way when compared to other ownership types. By contrast, listed firms controlled by SAMBs do badly in almost every respect. SOELG controlled firms are in the middle. We also find that Private investors, as the dominant shareholders of public firms, are not much better than SAMBs in terms of their associations with firm performance. The performance of Private controlled listed firms casts doubts on the claims that firms perform best when the state is completely absent from ownership (Dewenter and Malatesta, 2001, pp. 320–334), at least in the case of China.

This study contributes to the literature in several ways. First, it contributes to the literature on state versus private ownership. As we have Private controlled firms in our sample we can directly examine this issue in the context of China. In a transitional economy with a weak legal environment, the governance mechanisms of state and private ownership are different from those in either a planned economy or a developed market economy. We find that commercialized state ownership has its advantages in these circumstances. Thus, certain types of state ownership can be superior to private ownership when the institutional environment is relatively underdeveloped and when law enforcement is capricious and weak. Second, our study supplements the literature on transition economies. The type of privatization and the form of state ownership are major concerns in these economies (Stiglitz, 1999). We provide empirical evidence that certain types of state ownership help improve firm performance.

Finally, this paper contributes to the literature on ownership and control. We find that the relation between large shareholders and firm performance depends on who the large shareholders are. We document an alignment effect where higher ownership of the dominant shareholder is associated with better firm performance.

2. Ownership structure of China's listed companies

According to China's laws, a listed firm has six types of shares: state, legal person, foreign, management, employee, and individual shares. These shares have the same cash flow rights (e.g., they are entitled to the same dividends) and voting rights. Management, foreign, and employee shares represent less than 2% of the outstanding shares and so they do not constitute major voting blocks. State and legal person shares are not tradable on the stock exchange and they have concentrated ownership. In contrast, domestic individual shares are tradable and widely held.

Prior studies have generally focused on the relations between state shares, legal person shares, individual shares, and firm performance (Wei, Xie and Zhang, 2005, pp. 87–108). However, placing reliance on the legal definition of shares to infer investor type is very simplistic and ignores institutional realities (Green, 2004, working paper). Most importantly, legal person shares can be owned by a number of heterogeneous entities, ranging from solely state owned enterprises to private firms. These entities have different objectives and incentives and so grouping them together, as done in previous studies, distorts the results and leads to erroneous conclusions. Similarly, state shares can be owned by different types of investors. Another problem that has plagued prior research is the failure to identify the dominant shareholder and who that entity (or person) is. In this study, we investigate the ownership of China's listed companies based on the real identity of the large shareholders.

Our detailed investigation uncovers four main types of controlling shareholders in China's listed companies. They are state asset management bureaus (SAMBs), SOEs affiliated to the central government (SOECGs), SOEs affiliated to the local government (SOELGs), and Private investors. All of these investors exercise their control through the ownership of state or legal shares.

2.1 The state asset management bureaus (SAMBs)

SAMBs typically own the state shares and sometimes the legal person shares of the listed firms they invest in. In most provincial cities, a state asset management bureau, or the state asset operating company, has been established to manage state assets. SAMBs are shareholding institutions that belong to the state.

2.2 SOEs affiliated to the central government (SOECGs)

SOECGs refer to the 157 SOEs controlled by the central government under the State-owned Assets Supervision and Administration Commission (SASAC). Branches of the central government established these SOEs. Administratively, these SOEs belong to and are closely monitored by the central government, but they are located across the country and are involved in various industries. These companies are usually big and/or nation-wide companies, such as Sinopec Corp., the China Merchants Group, and so on. They are subject to strict monitoring.

2.3 SOEs affiliated to local governments (SOELGs)

SOELGs are SOEs controlled directly by a local government. These SOEs constitute the largest group of controlling shareholders of listed companies in China. The listed companies they control are typically spin-offs from the SOE.

SOELGs and SOECGs operate as profit-making entities and they can invest in the 'state' and 'legal person' shares of listed firms.

2.4 Private investors

This group of large shareholders includes both private firms and individuals. However, listed firms directly controlled by individuals only appear after 2001 when the 'Tian Tong Corp.' was listed, since prior to 1998 Chinese laws prohibited natural persons from directly holding more than 0.5% of the shares of a listed company. In most cases a Private investor becomes the largest controlling shareholder through the acquisition of non-tradable shares of the former large state shareholders either at the time of the IPO or subsequently. More recently, there are cases where a Private investor has built up a company and then listed it on the stock exchange. The shares held by controlling Private investors are usually legal person shares and at the time of our study they could not be traded on the stock market.

3. Motivations of controlling shareholders

Firms that have a Private investor as their dominant shareholder are actively monitored by that shareholder. Indeed, the Private investors often install themselves or their representatives as the CEO and the chairman of the listed firm. A Private investor typically has detailed knowledge of the industry in which the firm operates and so they can more easily enter into the management function or more effectively monitor the hired managers. A Private investor receives the cash dividends paid by the listed firm and the investor (if it is a company) uses consolidated or equity accounting to incorporate the listed firm's earnings into its own income statement. Agency problems associated with the separation of ownership and management will be small when a Private investor is the dominant shareholder. A much bigger concern for the minority shareholders of listed firms that are controlled by a Private investor is that their income and assets could be diverted or expropriated away by the dominant investor6 (Shleifer and Vishny, 1997, pp. 737–783). Unlike SAMBs and SOEs, Private investors are not subject to monitoring by the state and so it is easier for a controlling Private investor to expropriate (or tunnel) the income and assets of the listed firm away from the minority shareholders. Private controlled listed firms are therefore subject to a greater risk of diversion of assets by large shareholders. Given these conflicting influences, we do not know a priori whether firms controlled by Private investors perform better than those controlled by state entities.

While SAMBs and SOEs are ultimately owned by the state, they are different in many respects. First, SAMBs and SOEs differ as owners of listed companies in terms of the risk borne and benefits shared. Officials of SAMBs have the right to select the boards of directors and managers of SOEs, but bear no risks of the consequences of their selections (Zhang, 1998, working paper). Therefore, voting rights in their hands are typically 'cheap vote rights' (Harris and Raviv, 1988, pp. 203–235). The promotion of SAMB officials depends largely on how well they execute the instructions of the central or local government rather than on how much they contribute to creating firm value and dividend revenues. Political intervention is more likely if a listed firm is controlled by a SAMB.

SAMB officials are civil servants paid by the government and their remuneration and rewards have nothing to do with the performance of the listed companies they oversee. The SAMBs collect the dividends distributed by listed firms and deliver them to the state treasury. The officials have no right to use these dividend revenues. Therefore, the officials' well-being is not tied to the performance of the firms they are delegated to control. The SAMB officials typically have no relevant industry experience and so they lack the necessary skills to effectively monitor a firm's managers and they lack the knowledge to provide strategic advice. This problem is exacerbated as the officials have to look after the state's shareholdings in many firms and these firms are in a diverse set of industries. In addition, SAMBs are prohibited from being very close to the listed companies they control and this increases information asymmetry. Of all the ownership types, SAMBs are the least likely to expropriate wealth away from the minority shareholders (Deng, Gan and He, 2007, working paper).

SOEs have both the motives and the expertise to monitor managers of the listed spin-off firms and to provide strategic advice. Cash flows (dividends) and earnings (via consolidated and equity accounting) of listed firms flow through to the SOE investors and so they have incentives to appoint good managers and to monitor them. The motivations of SOEs to expropriate assets from a listed firm, and their ability to do so, lie somewhere between those of SAMBs and Private investors. While SOEs can benefit from expropriations, these investors are subject to monitoring by government ministries and state regulators. In summary, compared with SAMBs, SOEs have better risk bearing and benefit sharing mechanisms, exercise better monitoring, and are subject to less political intervention.

Distinctions should be made among SOEs affiliated to the central government (SOECGs) and those affiliated to local governments (SOELGs). First they differ as to the extent of the monitoring to which they are subject. SOECGs belong to the central government and are subject to strict supervision and monitoring from a number of departments under the central government including the National Audit Office (NAO). The chairmen of SOECGs are carefully chosen for their ability and many of them eventually become Vice Ministers of the state. It is important that these chairmen do well in their jobs so that they do not jeopardize their move up the state hierarchy. Local governments manage the state's assets

(via SOELGs) according to national law and regulations although they can also make their own policies, especially in terms of designing the organization's hierarchy. SOELGs are subject to the supervision and management either of the local government directly, or of state asset management bureaus at the local government level. SOECGs and SOELGs also differ in how well they observe the laws and regulations of China. Laws and regulations are more difficult to enforce the further away the parties are from the center of power and so SOELGs are subject to weaker supervision and management. Based on the motivations of SOEs and the degree of monitoring they face (by the government) we argue that SOECGs are more effective as dominant shareholders of listed firms than are SOELGs.

4. Empirical research

Table 1 reports the mean and median operating performance for firms with different types of largest shareholders and tests the significance of differences between the groups. The table shows that operating performance does differ for firms with different types of largest shareholders. For example, the mean (median) industry adjusted ROA for SAMBs is −2.96% (−1.07%) (see, Table 1, Panel B) whereas the mean (median) industry adjusted ROA for SOECGs is 0.88% (0.54%). Therefore, SOECG controlled firms have higher industry adjusted ROAs than SAMB controlled firms. Statistical significances of the differences in means and medians across different comparisons are shown in Panels C and D, Table 1. For example, the t-statistic (Z-statistic) of 9.05 (9.90) in the comparison of SOECG versus SAMB (see Panel C, Table 2) shows that the mean (median) ROA is significantly higher for SOECG controlled firms than for SAMB controlled firms. The results in Panels C and D of Table 2 can be summarized as follows. SOECG controlled firms are better than SAMB controlled firms in every respect except Tobin's Q where the difference is not statistically significant. Compared with firms controlled by SAMBs, firms controlled by SOELGs perform better across all performance measures except Tobin's Q. Compared with firms controlled by SAMBs, Private controlled firms have higher sales per employee and Tobin's Q. However, the results from a comparison of profit ratios are inconsistent. Firms controlled by SAMBs show higher cash flow returns (CFOA), while Private controlled firms show better earnings (ROA). SOECG controlled firms are superior to Private and SOELG controlled firms in all the measures except Tobin's Q (for the Private comparison). Finally, the comparisons between Private and SOELG show that SOELGs have better performance measures except for sales per employee and Tobin's Q. In summary, the simple comparisons of means and medians of raw and industry adjusted performance indicate that firms controlled by SOECGs do best, those controlled by SAMBs and Private do worst, and those controlled by SOELGs are in-between.

To summarize the results from Table 1 and Table 2, SAMBs demonstrate the poorest performance of the four groups of controlling shareholders of China's listed companies while SOECGs perform the best. SOELGs are in between SAMBs and SOECGs while Private controlled firms do little better than SAMB firms. The results are consistent with our expectations which are based on the motivations of the different types of owners.

5. Tests of reverse causality

A potential problem with our results is endogeneity or reverse causality. It is conceivable that when the government decides to privatize the productive units of SOEs, they allocate the more profitable ones to a specific type of owner. If this is the case, then it will be difficult to ascribe a firm's performance to the influence of its dominant shareholder. To test whether initial ownership types are influenced by firm performance, we construct a sample of 540 IPO firms that were listed in the period 1998–2004 and extract their operating performances for the first year after they were listed. We then use multinominal logit regression models to explore whether their operating performances influences the initial choice of ownership type. The models follow Schmidt and Strauss (1975, pp. 745–756).

The untabulated results from the multinomial logit regressions show that the coefficients on operating performance are not significant. This indicates that the choice of initial ownership type for a Chinese listed company is not influenced by the company's operating performance at that time and so reverse causality does not appear to be a problem. Our evidence is consistent with (Aivazian, Ge and Qiu., 2005, pp. 791–808), (Wei, Xie and Zhang, 2005, pp. 87–108), (Wang, 2005, pp. 1835–1856) and (Deng, Gan and He, 2007, working paper) who, in different contexts, conclude that the Chinese government does not use the profitability of SOEs as a criterion in deciding which SOEs to corporatize and what the initial ownership structure should be.

6. Conclusions

This study investigates the relations between types of large shareholders, ownership structure, and firm performance. We find that state shareholders differ in their management and monitoring effectiveness. The bureaucratic SAMBs perform worst, the SOECGs perform best, and the SOELGs are in-between. Private controlled listed firms are not superior to SOE controlled companies and are only marginally better than SAMB control. Our results contrast with prior research studies that conclude that state ownership is harmful to listed firms. The difference in findings is due to our focus on who actually owns the shares rather than the share type. Furthermore, we go to great lengths to explain the different objectives of the different types of owners and how this impacts on firm performance. We find no evidence to suggest that the initial choice of controlling shareholder (usually a choice made by, or with the blessing of, the state) is

dependent on a firm's performance. In additional tests, we find that ownership concentration is positively related to the operating performance of the firms but there are no significant non-linear effects. A variety of robustness checks confirm the results.

The results provide support for our argument that listed firms controlled by SAMBs have poorer performance than other types of ownership. The virtual absence of incentives and the lack of skills of the SAMBs (and their officials) to closely monitor the listed firms they control leave those firms bereft of leadership and oversight. In contrast to much received wisdom, we find that, in the context of China, listed firms that are controlled by Private investors do not perform the best. Our results are consistent with the suggestion of Stiglitz (1999) that market oriented state shareholders may be the most suitable controlling owners of firms in countries with weak institutional environments.

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Table 1. Operating performance for firms with different types of largest shareholders (A)

	SAMB			SOECG			SOELG			Private			All		
	Obs.	**Mean**	**Median**	**Obs.**	**Mean**	**Median**	**Obs.**	**Mean**	**Median**	**Obs.**	**Mean**	**Median**	**Obs.**	**Mean**	**Median**
Panel A: Raw															
ROA	968	0.42%	2.00%	839	4.43%	4.12%	3065	3.19%	3.56%	1241	0.75%	3.06%	6113	2.43%	3.29%
CFOA	968	4.53%	4.24%	839	6.20%	5.52%	3065	5.13%	4.86%	1241	3.18%	3.42%	6113	4.79%	4.52%
ROS	964	−7.32%	3.35%	838	7.13%	6.21%	3042	2.68%	6.41%	1209	−13.11%	6.92%	6053	−1.45%	5.97%
AEMP	946	1.797	0.608	827	2.399	0.893	3009	2.082	0.650	1221	2.696	0.873	6003	2.206	0.715
SEMP	947	0.931	0.310	828	1.849	0.522	3006	1.054	0.319	1209	1.045	0.312	5990	1.143	0.341
Tobin's Q	968	2.792	2.446	839	2.865	2.419	3065	2.705	2.351	1241	3.293	2.616	6113	2.860	2.422
Panel B: Industry median adjusted															
ROA	968	−2.96%	−1.07%	839	0.88%	0.54%	3065	−0.40%	0.06%	1241	−2.12%	0.19%	6113	−0.98%	0.00%
CFOA	968	0.16%	−0.03%	839	1.49%	0.54%	3065	0.32%	0.01%	1241	−0.60%	−0.12%	6113	0.27%	0.00%
ROS	964	−14.33%	−2.10%	838	−0.96%	−0.38%	3042	−5.38%	−0.07%	1209	−19.37%	0.86%	6053	−8.99%	−0.21%
AEMP	946	0.816	−0.080	827	1.452	0.150	3009	1.170	−0.015	1221	1.524	0.016	6003	1.225	0.000
SEMP	947	0.512	−0.043	828	1.457	0.168	3006	0.680	−0.002	1209	0.594	−0.043	5990	0.743	−0.001
Tobin's Q	968	0.236	−0.018	839	0.326	0.005	3065	0.194	−0.048	1241	0.796	0.179	6113	0.341	−0.003

Table 2. Operating performance for firms with different types of largest shareholders (B)

	SOECG vs SAMB		**SOELG vs SAMB**		**Private vs SAMB**		**SOECG vs SOELG**		**SOECG vs Private**		**SOELG vs Private**	
	Mean[a]	**Median[b]**	**Mean[a]**	**Median[b]**	**Mean[a]**	**Median[b]**	**Mean[a]**	**Median[b]**	**Mean[a]**	**Median[b]**	**Mean[a]**	**Median[b]**
Panel C: Test of RAW differences												
ROA	9.050***	9.900***	8.408***	9.624***	0.618	4.702***	4.179***	2.999***	7.115***	5.636***	7.166***	4.127***
CFOA	3.930***	3.891***	1.876*	2.510**	−3.266***	−2.877***	3.039***	2.426**	6.699***	6.344***	6.196***	6.038***
ROS	6.025***	7.866***	5.300***	9.396***	−1.607	6.732***	2.833***	0.336	6.142***	0.989	7.391***	0.834
SEMP	2.121**	9.053***	1.303	2.775***	3.139***	7.309***	1.217	8.370***	−0.911	1.760*	−2.769***	−6.397***
AEMP	3.884***	10.871***	0.911	2.467**	0.788	1.443	4.386***	10.975***	3.832***	9.649***	0.080	0.763
Tobin's Q	0.999	0.237	−1.615	−1.660*	5.101***	3.488***	2.825***	1.848*	−4.065***	−2.961***	−9.206***	−6.069***
Panel D: Test of industry median adjusted differences												
ROA	8.865***	9.761***	7.892***	8.619***	1.563	6.806***	4.588***	3.877***	5.914***	3.337***	5.131***	0.069
CFOA	3.254***	3.261***	0.529	0.870	−1.838*	−0.991	3.466***	3.115***	4.797***	4.142***	2.987***	2.113**
ROS	5.612***	6.365***	4.802***	7.522***	−1.399	7.540***	2.869***	0.385	5.591***	−1.687*	6.588***	−2.812***
SEMP	2.339**	8.628***	1.865*	4.987***	2.581***	4.313***	1.128	6.151***	−0.235	4.022***	−1.682*	−0.659
AEMP	4.018***	12.407***	1.250	5.977***	0.571	0.343	4.321***	10.337***	4.143***	11.757***	0.749	5.616***
Tobin's Q	1.418	1.112	−0.935	−0.570	6.110***	6.517***	2.724***	1.908*	−4.793***	−5.082***	−10.340***	−9.166***

Notes: The table reports both raw (RAW) and industry median adjusted (IA) measures of operating performance. ROA/CFOA is operating earnings/cash flows deflated by the average book value of the total assets. ROS is operating earnings deflated by net sales. AEMP is the ratio of the average book value of total assets to the number of employees in RMB millions. SEMP is the ratio of net sales to the number of employees in RMB millions. Tobin's Q is market value of total assets deflated by the average book value of total assets, where market value of total assets is the sum of monthly average market capitalization and average total debts. For some measures, the numbers of observations are slightly smaller than the sample sizes due to missing values.***, **, and * represent statistically different from 0 in T-test for means and in the Mann-Whitney U-test for medians at the 1%, 5%, and 10% levels, respectively.

a. t-value from the T-test of differences in means.

b. Z-value from the Mann-Whitney U-test of differences in medians.