Corporate Finance

Lecture 5: Corporate Finance in China

Tong Li (李通)

SOE & WISE, Xiamen University

Email: litong@xmu.edu.cn

Quick Review of Last Lecture

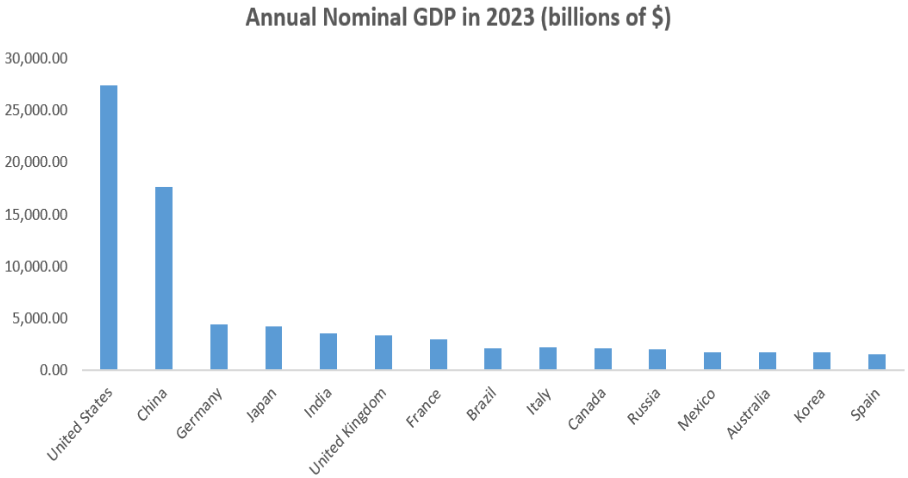
- Corporate ESG practices can be measured in various ways. In addition to aggregate ESG ratings/scores, it is useful to consider 1) individual component of ESG issues and 2) apply advanced techniques and alternative datasets to construct your own measure.
- Many factors can drive corporate ESG practices, including, but not limited to CEO characteristics, firm characteristics, ownership structure, and regulations.
- Shareholder Capitalism vs. Stakeholder Capitalism
- Various views regarding motives for corporate ESG engagement: win-win (doing well by doing good); delegated ESG; greenwashing; insider-initiated corporate philanthropy
- Four levers driving ESG's value creation: profitability, investment efficiency, growth, risk.
- ESG is typically associated with higher profitability, although the findings are inconclusive.
- The effects of ESG engagement and investment efficiency needs further exploration.
- Socially responsible firms achieve a higher sales growth rate.
- ESG engagement could significantly affect (typically reduce) various types of risk.

Outline for This Lecture

1. Why Should We Focus on China?
2. Typical Chinese Characteristics
3. China and Other Countries
4. Review Papers on China

Why Should We Focus on China?

- China is now the second largest economy in the world.

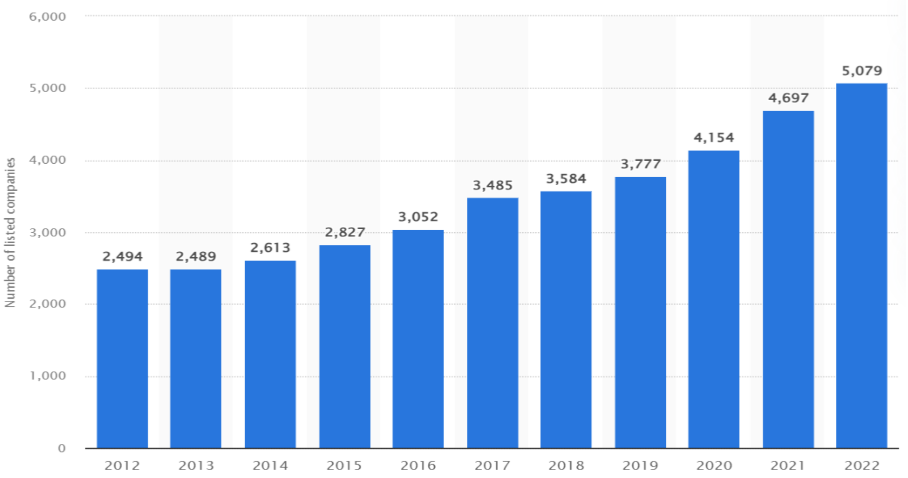


Why Should We Focus on China?

- China now has many globally influential corporations.

Why Should We Focus on China?

- China's capital market is young but is evolving rapidly.



Why Should We Focus on China?

- Many regulatory initiatives and governmental interventions that were introduced to liberalize capital markets over the last two decades.
- The regulations often deal with new ideas in terms of corporate governance, access to capital, investor protection, and societal objectives (such as fighting corruption or pollution).
- China is different from the USA, and what is known about the USA cannot simply be applied to China.
- China is similar to many other non-US countries so that insights from China can be applied to countries far beyond China.

Why Should We Focus on China?

- Many novel datasets about China have become available.

Typical Chinese Characteristics

- Dominance of Unsophisticated Retail Investors
- Dominance of State-owned Enterprises
- Role of Government
- Pro-ESG Trends in China

Dominance of Unsophisticated Retail Investors

- **99.76%** of the investment accounts are owned by retail investors as of 2022.
- **95.99%** of retail investors hold less than 500,000 RMB in their investment accounts.
- Retail investors dominate trading and account for nearly **90%** of daily trading volume on the Shanghai Stock Exchange (Titman, Wei, and Zhao, JFE 2022).
- As of March 2021, retail investors hold **33%** of the total floating market capitalization, which is comparable to the US market.
  - However, the majority of institutional investors in China are legal-person entities, who represent large shareholders (such as government entities owning major stakes in SOEs), rather than institutional investors, such as insurance companies, mutual funds, and pension funds.
  - Legal-person entities hold 45% of the total floating market capitalization – substantially higher than professional institutional investors, who hold 17%.
- Approximately **1/3** of all Chinese retail investors lack a high school education (Gan et al., 2015)

Dominance of Unsophisticated Retail Investors

- Retail investors have unique behavior:
  - Feng and Seasholes (2004, JF): trading is highly correlated among investors who are geographically close.
  - Jones, Shi, Zhang, and Zhang (2023): retail investors with small account sizes fail to process public news, and show overconfidence and gambling preferences.
- The presence of retail investors in China is associated with
  - excessive trading of small local stocks (Hong et al., RFS 2014)
  - overpricing (Choi, Jin and Yan, 2013)
- Retail investors' impact on corporate behavior:
  - Titman, Wei and Zhao (2022, JFE): some firms manipulate stock prices around stock splits and expropriate retail investors.

State-owned Enterprises (SOEs)

- At the start of China's capital market, all listed companies were SOEs.
- SOEs currently account for one-third of firm numbers but two-thirds of market capitalization.
- There usually exist conflicts of interest between the state controlling shareholder and minority shareholders.
  - SOEs often focus on political objectives (e.g., maintain social stability) rather than value maximization.
- SOEs in China tend to suffer from agency issues similar to those in many developed countries, like the USA.
  - Since state owners do not actively oversee day-to-day operations, managers may be able to engage in self-serving behavior at the expense of both state and minority shareholders.

Role of Government in China

- Li, Meng, Wang, and Zhou (2008): positive effects of political connections
  - The Party membership of private entrepreneurs has a positive effect on their firms' performance.
  - Party membership helps private entrepreneurs to obtain loans from banks or other state institutions, and affords them more confidence in the legal system.
  - Party membership to be more important to firm performance in regions with weaker market institutions and weaker legal protection.

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- Duchin, Gao, and Shu (2020, RFS): negative effects of government involvement
  - Weaker government involvement, measured by greater distance from government, is associated with higher firm autonomy and reduced taxes, protectionism, and anticompetitive behavior.
  - Distant firms tend to have better operating performance, higher growth, and higher entry rates.
  - Similar results around exogenous government office relocations.

Role of Government in China

- Colonnelli, Li, and Liu (2024, JPE): investor preferences for government participation in China's VC and PE markets
  - A large-scale field experiment to elicit preferences for government participation in China's venture capital and private equity market
  - The average firm dislikes investors with government ties.
  - Such dislike is not present with government-owned firms.
  - Such dislike is highest with best-performing firms.
  - Political interference in decision-making is the leading reason why government investors are unattractive to private firms.

Anti-Corruption in China

- Agarwal, Qian, Seru, and Zhang (2020, JFE): a disguised form of corruption in China
  - A comprehensive sample of credit card data from a leading Chinese bank
  - Government bureaucrats receive 16% higher credit lines than non-bureaucrats with similar income and demographics, but their accounts experience a significantly higher likelihood of delinquency and debt forgiveness.
  - Regions associated with greater credit provision to bureaucrats open more branches and receive more deposits from the local government.

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- Lin, Morck, Yeung, and Zhao (2016): positive market reactions to anti-corruption campaigns
  - China's markets gained 3.86% around December 4, 2012, when the Party announced anti-corruption reforms.
  - State-owned enterprises (SOEs) with higher past entertainment and travel costs (ETC) gained more.
  - Non-SOEs gained in regions with strong market mechanisms.

Anti-Corruption in China

- Griffin, Liu, and Shu (2022, MS): limited impact of anti-corruption campaign on firms
  - The largest anti-corruption campaign in modern history: a total of 2.9 million people were punished from 2013 to 2019.
  - Consistent with the campaign ensnaring corrupt firms, investigated firms have lower minority shareholder ownership, higher abnormal CEO compensation, more near-retirement CEOs, more related-party loans and receivables from parent, higher business entertainment expenditures, more operational and investment inefficiencies, and more corruption postings.
  - There is a large decrease in highly visible business entertainment expenditures and a decrease in CEO pay for SOEs.
  - There has not been a broad improvement in corporate corruption indicators and corporate culture for Chinese firms as a whole.

Pro-ESG Trends in China

- Chen, Hung, and Wang (2018, JAE): mandatory CSR disclosure and corporate behavior
  - China's 2008 mandate requiring firms to disclose CSR activities
  - Mandatory CSR reporting firms experience a decrease in profitability subsequent to the mandate.
  - The cities most impacted by the disclosure mandate experience a decrease in their industrial waste water and SO2 emission levels.
  - Mandatory CSR disclosure alters firm behavior and generates positive externalities at the expense of shareholders.
- Kong and Liu (2024): centralization of authority in the appointment of civil servants $\rightarrow$ effectiveness of regulatory enforcement efforts
  - A unique personnel reform in China's Environmental Protection Bureaus (EPBs), which shifts the power to appoint local EPB directors from municipal governments to the provincial level
  - Local EPB directors under centralized personnel authority increase the number of punishments and the total amount of fines by 13.0% and 19.0%, respectively.

Pro-ESG Trends in China

- Cui, John, Pang, and Wu (2018): stronger labor protection laws increases corporate cash holdings
    - In 2007, China passed the Labor Contract Law, which came into effect on January 1, 2008.
    - It specifies the nature of contracts that employers are obligated to provide to employees, increases severance payments to laid-off workers and, for the first time, specifies explicit penalties for firms that do not comply with the law.
    - Labor-intensive firms in China significantly increase their cash holdings following the law's enactment.
    - The impact of the law is concentrated on areas with strict law enforcement, state-owned enterprises, and industries that employ large numbers of migrant workers.
    - Employment protection increases labor adjustment costs and hence the expected costs of financial distress for labor-intensive firms.

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- Mayneris, Poncet, and Zhang (2018): corporate responses to minimum wage variations
  - The 2004 minimum-wage reform in China: more workers covered by the minimum wage, more frequent minimum wage adjustments and an hourly minimum wage created for part-time workers.
  - Labor costs and productivity increase following the reform.
  - Profitability did not change and job losses were limited.

Effects of Foreign Countries on China

- Giannetti, Liao, and Yu (2015, JF): directors with foreign experience improve firm performance
  - The flows of students from China toward universities in the developed world started since the late 1970s and became sizable in the early 1990s.
  - Starting in the late 1990s, provincial governments adopted policies to attract highly skilled emigrants and did so at different points in time.
  - The policies' main objectives were increasing the quality of academic and industrial research, fostering entrepreneurial activity, and promoting the entry of new businesses.
  - The policies only targeted the most distinguished Chinese expatriates.
  - The policies included tax breaks, subsidized housing, tax-free imports of automobiles and computers, schooling for the children of the returnees, local grants and awards, medical benefits, jobs for spouses,and long-term residence permits.
  - This paper shows that performance increases after firms hire directors with foreign experience.
  - A "brain gain" channel: directors transmit knowledge about management practices and corporate governance to firms in an emerging market.

Effects of Foreign Countries on China

- Lin and Ye (2018, RFS): FDI facilitates the transmission of global liquidity shocks
  - Capital account openness and the international transmission of financial shocks is a central issue in international finance.
  - Existing studies have mainly focused on openness to portfolio equity flows and debt flows, with little attention paid to the role of openness to foreign direct investment (FDI) flows.
  - China and the group of low-openness economies are rather restrictive toward non-FDI flows, but they are more open to FDI inflows than the United States and Japan in the de facto sense.
  - FDI firms provide more trade credit than local firms during tight domestic credit periods.
  - A favorable global liquidity shock amplifies FDI firms' advantage in trade credit provision.
  - The differential responses of FDI and local firms are stronger in financially more dependent industries or in Chinese provinces with less financial depth.
  - Even in countries like China that impose strict controls on cross-border portfolio flows, the presence of FDI firms creates a trade credit channel through which global liquidity conditions can influence host countries' economic activities.

Effects of Foreign Countries on China

- Jia, Wang, and Xiong (2017, RFS): differential reactions of local and foreign investors to analyst recommendations
  - There are persistent and substantial price deviations between dual-class shares issued by the same firms to local and foreign investors in segmented markets.
  - A common explanation of such price deviations is the difference in discount rates of local and foreign investors due to their different risk exposures and preferences.
  - This paper explores differential reactions of local and foreign investors to analyst recommendations as a new explanation.
  - A unique setting of segmented dual-class shares issued by a set of Chinese firms: A shares traded in mainland China by local investors and H shares traded in Hong Kong by foreign investors
  - A share (H share) prices have significantly stronger reactions to recommendation changes made by analysts of local (foreign) houses.
  - Social connections between analysts and investors affect investor reactions to analyst recommendations.

Review Papers on China

- Allen, Qian, and Qian (2019): a review of China's institutions
- Hu and Wang (2022): a review of China's financial markets
- Jiang and Kim (2020): a review of corporate governance in China
- Lennox and Wu (2022): a review of China-related accounting research
- Cheng, Hail, and Yu (2023): a review of China-related accounting research
- Lu, Shin, and Zhang (2023): a review of financial reporting and disclosure practices in China