

Politically Connected CEOs, Corporate Governance, and the Post-IPO Performance of China's Partially Privatized Firms

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Many scholars have argued that the protection of local industries from competition and the extraction of “private benefits” are important objectives of politicians’ intervention in business activities, and that such intervention tends to be more intrusive in countries with weak institutional constraints.¹ What’s more, a considerable body of research has shown that countries with weaker property rights and limited protection against expropriation by politicians and the country’s elite have substantially lower income per capita and investment rates, as well as less developed stock markets.

This article summarizes the arguments and findings of our study of government intervention in China’s newly partially privatized firms. Because property rights in China remain weak and the product and capital markets are far from liberalized, one would expect a strong negative relation between government intervention and the performance and governance quality of the affected firms.

And, indeed, the effects of China’s share issue privatization on corporate performance stand in sharp contrast to the experience in other economies, where privatization has generally led to performance improvement.² Accordingly, our study attempted to answer three questions about China’s partial privatizations: (1) What was the effect of government influence on the privatized companies’ longer-term, post-IPO stock returns and operating performance? (2) Did the post-IPO stock market performance reflect the effects, if any, of government influence; and if so, when did such effects show up? and (3) Were the governance and board composition of such firms affected in discernible ways by government intervention?

In conducting our study, we used the CEO’s “political connection,” which we defined as serving as a current or

former government bureaucrat—that is, a current or former officer of the central or local governments or the military—as a proxy for government intervention in the firm. Because the Chinese government has the right to appoint the CEO of a listed company, the CEO’s political affiliation provides a suitable proxy for government influence. Our analysis of a detailed database of CEOs and directors of 790 companies that went public in China between 1993 and 2001 (nearly 73% of all IPOs) shows that almost 27% of CEOs were politically connected. After controlling for other factors that influence firm performance, we found that long-term post-IPO stock returns were significantly worse when a firm’s CEO is politically connected. Moreover, this difference in stock return performance was noticeable soon after the initial listing and became statistically significant around 40 days after the new issue. The operating performance of companies run by politically connected CEOs was also consistently worse than that of otherwise comparable firms. After controlling for other factors, we also found that shareholder returns on the day of the IPO were negatively related to the CEO’s political connections, which suggests that China’s IPO investors anticipate the negative effects of government intervention and hence lower the prices they are willing to pay for these stocks. The evidence also suggests that politically unconnected firms underprice their IPO shares more than do politically connected firms, which could serve as a signal to investors that the firms will be less subject to intervention by bureaucrats.³ Finally, we found that the boards of our sample firms had almost no directors who represent public stock investors; and that when CEOs are politically connected, boards tend to have more bureaucrats and fewer professionals, and the directors are on average older and less likely to be women.

* This is a shorter, less technical version of the authors’ paper that was published in the *Journal of Financial Economics*, Vol. 84 No. 2 (2007), pp. 330-35.

1. See George J. Stigler, “The theory of economic regulation,” *Bell Journal of Economics and Management Science* 2, 3-21, 1971; Sam Peltzman, “Toward a more general theory of regulation,” *Journal of Law and Economics* 19, 211-240, 1976; F.S. McChesney, “Rent extraction and rent creation in the economic theory of regulation,” *Journal of Legal Studies* 16, 101-118, 1987; Hernando De Soto, *The Other Path*, Harper and Row, New York, 1990; P. Spiller, “Politicians, interest groups, and regulators: a multiple-principals agency theory of regulation, or let them be bribed,” *Journal of Law and Economics* 33, 65-101, 1990; Andrei Shleifer, Robert Vishny, “Politicians and firms,” *Quarterly Journal of Economics* 109, 995-1025, 1994; Andrei Shleifer, Robert Vishny, “The Grabbing Hand: Government Pathologies and Their Cures,” Harvard University Press, Cambridge, MA, 1998; J.S. Hellman, G. Jones, D. Kaufmann, D., “Seize the state, seize the day: state capture, corruption, and influence in transition,” *World Bank Policy Research Working Paper*, no. 2444. Washington D.C., 2000; Daron Acemoglu

and Simon Johnson, “Unbundling institutions,” *Journal of Political Economy* 113, 949-995, 2005.

2. See, for example, W.L. Megginson, R.C. Nash, M. Randenborgh, “The financial and operating performance of newly-privatized firms: an international empirical analysis,” *Journal of Finance* 49, 403-452, 1994; N. Boubakri, J. Cosset, J., “The financial and operating performance of newly privatized firms: evidence from developing countries,” *Journal of Finance* 53, 1083-1112, 1998; W.L. Megginson, R.C. Nash, J.M. Netter, A. Schwartz, “The long-term return to investors in share issue privatizations,” *Financial Management* 29, 67-77, 2000.

3. This result corroborates prior research findings that IPO firms in market-oriented economies tend to underprice more than do those in interventionist economies. See E. Perotti, “Credible privatization,” *American Economic Review* 85, 847-859, 1995; S. L. Jones, W.L., Megginson, R.C. Nash, J.M. Netter, “Share issue privatizations as financial means to political and economic ends,” *Journal of Financial Economics* 53, 217-253, 1999.

Taken together, our findings provide persuasive evidence that China's partial privatizations and ongoing government intervention (as reflected in the political connections of the firms' CEOs) are not conducive to shareholder value maximization. The high involvement of bureaucrats and the low participation of professionals in management and directorships along with the poor post-IPO performance are perhaps not surprising results of China's share issue privatization scheme.⁴

The Rationale for our Study

During the economic reforms of the 1980s, the Chinese government launched a program that decentralized managerial decision rights of state-owned enterprises (SOEs) from the central government down to the local firm level. The central government's plan was to promote markets and to gradually phase out its central planning function. In the 1990s, the government allowed SOEs to be partially privatized by issuing a minority allocation of shares to individual investors, who could trade their shares freely in newly developed stock markets set up in Shenzhen and Shanghai in 1990 and 1991, respectively.

But for ideological reasons, this partial privatization process, which was officially called *corporatization*, prohibited the government from selling its controlling stake in the firms. Therefore, unlike in most other countries where share issue privatizations are accomplished through secondary or mixed primary-secondary offerings, the Chinese privatizations were primary offerings that did not involve subsequent secondary offerings.⁵

In association with the corporatization process in the 1990s, the central government further decentralized its power by specifying the exact decision rights assigned to the SOE level—rights that were related mainly to operating decisions and the use of retained funds.⁶ But if the operating decision rights were largely granted to SOE managers, the government

retained ultimate decision rights concerning mergers and acquisitions and the disposal of shares and assets of these listed firms, as well as decision rights on the appointment of CEOs.

It is not difficult to forecast that, with this institutional background, the non-transferability of state-owned shares and assets would create thorny incentive problems among both government officials and firm managers. Under these conditions, corporate governance is likely to be ineffective and firm value to be dissipated, due fundamentally to the absence of a free market that would release the firms from state ownership.⁷ Moreover, conflicts of interest between shareholders and bureaucrats overseeing the firm, with the latter likely pursuing social objectives or private gains at the firm's expense, are further expected to decrease firm value.⁸

We assume that an interventionist government is more likely to endorse a bureaucrat's appointment as CEO of a newly listing company. A first test of whether a politically connected CEO and his or her affiliated government pursue objectives that run counter to corporate productivity was therefore to determine if the appointment is associated with poor long-term firm performance. If the government tends to extract rents from the firm, the appointment of a politically connected CEO would negatively affect post-IPO stock returns and operating performance, all else equal.

In a well-functioning capital market, the long-term negative effects of government intervention in the form of a politically connected CEO should be factored into a company's stock prices shortly after its stock is offered to the public. Likewise, the anticipated negative effects of government intervention should reduce the willingness of investors to pay high prices for the new shares. To be sure, the government could lower the offering price to boost demand for the new shares, making the net effect of the politically connected CEO on initial returns unclear. But this scenario seems unlikely because the limited supplied IPO shares in China are almost always oversubscribed. Therefore, we would not

4. This paper is related to several other strands of literature. First, it considers the governance and performance consequences when a substantial ownership block is non-transferable: Arrmen Alchian, "Some economics of property rights," *Il Politico* 30, 816-829, 1965. Reprinted in Arrmen Alchian, *Economic Forces at Work*. Liberty Press, Indianapolis, IN, 1977 (Originally published in 1961 by the Rand Corporation); Michael C. Jensen, William H. Meckling, "Rights and production functions: an application to labor-managed firms and codetermination," *Journal of Business* 52, 469-506, 1979; J.M. Karpoff, E.M., Rice, "Organizational form, share transferability, and firm performance," *Journal of Financial Economics* 24, 69-105, 1989. Second, it provides additional evidence on the effects of government ownership on post-privatization performance: S. Kole, J.H. Mulherin, "The government as a shareholder: a case from the United States," *Journal of Law and Economics* 40, 1-22, 1997; N. Boubakri, J. Cosset, O. Guedhami, "Liberalization, corporate governance and the performance of newly privatized firms," *Journal of Corporate Finance* 11, 767-790, 2005; N. Gupta, "Partial privatization and firm performance," *Journal of Finance* 60, 987-1015, 2005; and the afore mentioned, Megginson, and Nash, 2005. Third, it extends the literature on government intervention and rent seeking. Our evidence that bureaucrats seek rents from firms complements several recent studies that focus on political connections and rent seeking: A. Agrawal and C.R. Knoeber, "Do some outsider directors play a political role?" *Journal of Law and Economics* 44, 179-199, 2001; C.J. Hadlock, D.S Lee, R. Parrino, R., "CEO careers in regulated environments: evidence from electric and gas utilities," *Journal of Law and Economics* 45, 535-563, 2002; E. Helland, M.E., Sykuta, "Regulation and the evolution of corporate boards: monitoring, advising or window dressing?" *Journal of Law*

and Economics 47, 167-194, 2004; M. Faccio, "Politically connected firms," *American Economic Review* 96, 369-386, 2006.

5. Most of our sample firms did not actively engage in secondary offerings, nor did some of the firms' rights offering activities significantly dilute state ownership. We repeat our analysis on the sample excluding 58 firms that made secondary offerings subsequent to their IPOs, and find that our results are generally unaffected by the exclusion. Subsequent to primary offerings, government-owned shares can occasionally be transferred in blocks among state-owned firms. However, free trading of these shares in the secondary markets was strictly prohibited during our sample period.

6. Y. Qian, "Reforming corporate governance and finance in China," In: M. Aoki, K., Kim, (Eds.), *Corporate Governance in Transitional Economies*, World Bank, Washington, D.C., 1995.

7. Alchian (1965), Jensen and Meckling (1979), and Karpoff and Rice (1989) provide analyses on the effects of non-transferable property rights on organizations and incentives. When assets/shares are non-transferable, the firms cannot sell off its assets and/or controlling stakes to buyers who potentially can run the firms more productively. The prohibition against trading the shares also renders two governance mechanisms, incentive compensation contracts and corporate control, impractical. This problem is exacerbated by the absence of a large secondary owner who benefits from additional firm productivity by serving as a high-power monitor (Shleifer and Vishny, 1986).

8. Andrei Shleifer, Robert Vishny, "The Grabbing Hand: Government Pathologies and Their Cures," Harvard University Press, Cambridge, MA, 1998.

Table 1 **The sample**

This table presents information on the sample of newly partially privatized firms in China that went public during 1993 to 2001. Columns 1 and 2 report the number of firms and the percentage of the total initial public offering (IPO) population. Columns 3 and 4 report numbers on the subsample of firms led by politically connected CEOs. Panel A reports the sample by year of IPO. Panel B reports the sample by industry sector.

	Total sample		Firms with politically connected CEOs	
	Number	% of the total IPO population by year/sector	Number	% of the total sample by year/sector
<i>Panel A: By year</i>				
1993	59	47.58	9	15.25
1994	64	58.18	16	25.00
1995	12	50.00	3	25.00
1996	132	65.02	46	34.85
1997	172	83.50	46	26.74
1998	88	83.02	32	36.36
1999	80	81.63	21	26.25
2000	117	85.40	29	24.79
2001	66	83.54	9	13.64
<i>Panel B: By industry sector</i>				
Natural resources	48	78.69	19	39.58
Manufacturing	499	74.92	128	25.65
Services and trade	116	75.82	32	27.59
Public utilities	63	67.02	20	31.75
Finance & real estate	18	42.86	1	5.56
Conglomerate	46	64.79	11	23.91
Total	790	72.68	211	26.71

expect the marginally lower demand for the new shares due to the government intervention to be a major concern in the government's IPO pricing decisions.

On the other hand, prior studies have shown that non-interventionist governments will underprice IPO shares to signal investors their intent to relinquish control of the firm.⁹ Under this scenario, the CEO's political ties (which, again, are a proxy for government intervention) should be associated with smaller IPO underpricing (lower initial returns). Consistent with this signaling hypothesis, there should also be a significant difference in the long-term post-IPO performance among privatized firms on the basis of the CEO's political ties, as predicted earlier.

Finally, we began with a hypothesis about the effect of politically connected CEOs on the boards of the newly privatized firms. The structure of a board of directors reveals information about the quality of the firm's management and the extent of checks and balances on managerial decisions. The degree of professionalism and monitoring

required by a firm is likely to be determined by the institutional environment to which the firm adapts.¹⁰ We began with the expectation that the property regulations in China's privatization scheme would lead to boards characterized by strong bureaucratic influence, weak governance, and low professionalism. Specifically, we expected that firms with government-appointed, politically connected CEOs would have more directors with political ties and fewer directors with business experience or professional backgrounds, mainly because politically connected CEOs need allies on the board to reinforce their policies and objectives. Non-political professionals, or directors representing investors' interests, could stand in the way of politicians' objectives.

Our Study: Data and Sample

We manually collected CEO and board data from the IPO prospectuses of newly listed A-share companies on the Shanghai Stock Exchange and the Shenzhen Stock Exchange from 1993 to 2001.¹¹ For each company, we obtained a profile of

9. See, e.g., Perotti (1995); Jones, Megginson, Nash, and Netter (1999).

10. B.E. Hermalin, M.S. Weisbach, "Boards of directors as an endogenously determined institution: a survey of the economic evidence," *Economic Policy Review* 9, 7-26, 2003.

the CEO and each of the other directors from the company's prospectus. In addition to the CEO's or director's name, the profile typically contains information on age, gender, education, professional background, and employment history. From the profile, we traced the CEO's or director's political connections by examining whether he or she was currently or formerly an officer of either the central government, a local government, or the military. From the director's profile and the "Company History," "Background of Founding Investors," and/or "Background of Large Shareholders" sections of the company's prospectus, we further identified each director's current or former business experience outside the business group to which the newly listed company belongs.

We obtained CEO and board data for 790 IPO firms during the 1993 to 2001 period, representing 73% of the total number of IPO firms in China over that period and covering 7,255 CEOs and directors.¹²

Table 1 provides a summary description of our sample. As can be seen in Panel A of Table 1, the IPO firms in our sample are unevenly distributed across the sample period, which largely reflects the overall IPO pattern in China. The sample coverage improves over time, reflecting improved public disclosure of company information, especially after 1997. Panel B breaks down the sample by industry sector. Of the 790 firms, 48 firms are in the natural resources sector, 499 in the manufacturing sector, 116 in the services and trade sector, 63 in the public utilities sector, 18 in the finance and real estate sector, and the remaining 46 are classified as conglomerates operating in multiple sectors. The sample captures more than 65% of all IPO firms in each of the sectors, with the exception of the finance and real estate sector (43%).

Table 1 also reports that almost 27% of the sample firms appointed politically connected CEOs who were current or former government bureaucrats or military officers. This suggests that the government maintains direct influence on a significant portion of firms through its CEO appointments. There is no particular pattern in the percentage of politically connected CEOs on a year-by-year basis, but there is a cross-industry variation in the appointment of politically connected CEOs. The highest percentage of politically connected CEOs occurs in the natural resources sector (40%), followed by the public utilities sector (32%), the services and trade sector (28%), the manufacturing sector (26%), conglomerates (24%), and the finance and real estate sector (6%).

Post-IPO Performance

We used several stock- and accounting-based measures to evaluate the post-IPO performance of the Chinese companies in our sample. The stock performance measures were the one-, two-, and three-year post-IPO cumulative abnormal market-adjusted stock returns (CARs), calculated on the basis of monthly stock returns starting from the first month after the IPO date. We used the equally weighted market index of both the Shanghai and Shenzhen stock exchanges for adjustments in all our analyses, but our regression results remain qualitatively similar with value-weighted indexes.

We also used three measures of operating performance: sales growth, earnings growth, and the change in return on sales (ROS). We calculated ROS as net income divided by sales. We did not use return on book assets or return on book equity because Chinese share issue privatizations are primary offerings that increase the asset base of the firms substantially after the IPOs, creating a downward bias on performance measures based on equity or assets.

Prior research on share issue privatization performance typically compares operating performance changes a few years before and a few years after privatization.¹³ Consistent with this research, we used the pre-IPO accounting figures of a firm as a benchmark to evaluate the firm's post-IPO performance. We computed the change in ROS by subtracting the average ROS in the three years immediately prior to the IPO from the average of the three years of annual ROS after the IPO. The earnings (sales) growth measure was the percentage change in the average level of earnings (sales) over the three years immediately prior to the IPO to the three years after the IPO.¹⁴

Fig. 1 shows that the average CAR of newly listed firms in China not only failed to increase but actually fell by almost 17% during the three years after their IPOs. Fig. 2 plots the mean CARs of newly listed companies in China sorted by whether or not their CEOs are politically connected. The mean CAR of the group of firms run by politically connected CEOs exhibits a steep decline of 30% over the three years subsequent to the IPOs, while the mean CAR of the second group of firms exhibits a much smaller drop of 12% over the same period.

Table 2 reports the mean and median values of the stock-based and operating performance measures for the full sample and for subsamples sorted by whether or not the CEO is

11. During the sample period, A-shares were traded by domestic investors, versus other classes of shares such as B- or H-shares that were traded by foreign investors. Starting in 2001, domestic investors were allowed to trade B-shares.

12. In addition to the CEO/board data, we obtained IPO-year ownership data from the Shenzhen Genius Information Technology Company database; stock return and financial data from the China Stock Market and Accounting Research (CSMAR) database; and China's regional economic data from China Economic Information Network Data Co., Ltd.

13. See Megginson, Nash, and Randenborgh (1994); Boubakri and Cosset (1998); D'Souza and Megginson (1999); Sun and Tong (2003).

14. Note that we have omitted operating numbers in the IPO year because those data

tend to be heavily manipulated. In addition, if the CEO of a firm was politically connected prior to its IPO, we would not expect a change in its operating return measures after the firm went public. We would have to exclude such firms from the sample in our operating return analysis. However, we cannot discard these firms from the sample due to the lack of information on the political connections of the pre-IPO CEOs. This biases against finding a relation between political connections and accounting returns.

Due to missing pre-IPO data, the number of observations in the change in ROS and earnings growth statistics is 774, while it is 782 in the sales growth statistics. The pre-IPO sales and earnings data are missing for eight firms and the pre-IPO earnings data are missing for another eight firms. We also "winsorize" the top and bottom 5% of each of the accounting return variables to exclude the effect of outliers.

Figure 1

Mean post-IPO cumulative market-adjusted compound stock returns (CARs) from one to 36 months after the initial trading month of 790 partially privatized firms in China that went public during 1993 to 2001.

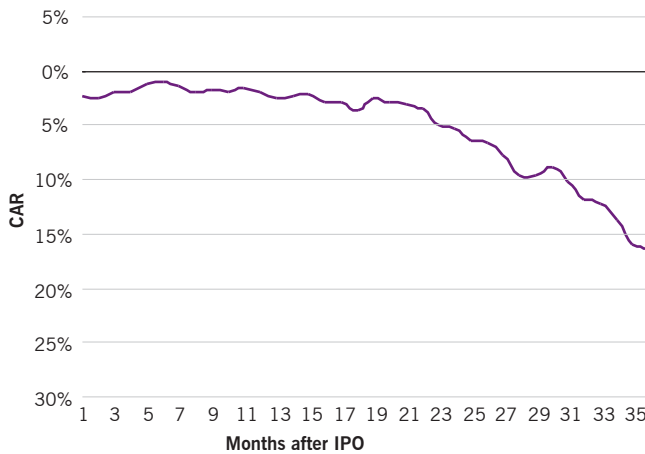


Figure 2

Mean post-IPO cumulative market-adjusted compound stock returns (CARs) from one to 36 months after the initial trading month of 790 partially privatized firms in China that went public during 1993 to 2001, sorted by whether their CEOs are current or former government bureaucrats..

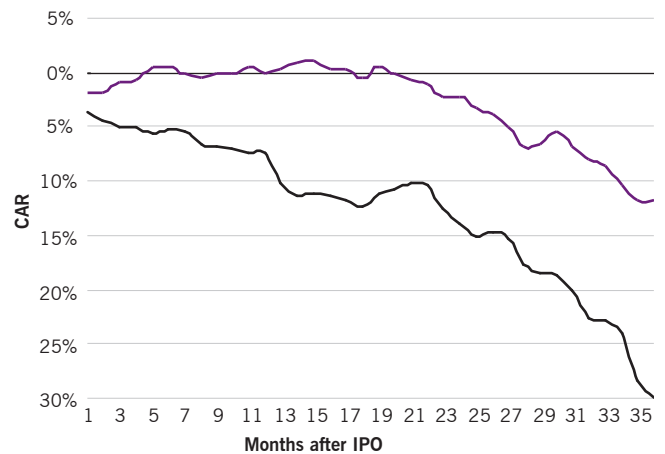


Table 2 Mean and median statistics of post-IPO performance measures

This table presents the mean and median values of stocks and accounting performance measures of Chinese firms that were partially privatized through IPOs during 1993 to 2001. The table also reports the statistics for two subsamples of firms sorted by whether or not their CEOs were politically connected. The stock performance measures are the cumulative market-adjusted stock returns (CARs) accumulated for 12, 24, and 36 months starting from one month after the IPO month. Monthly stock returns are used for calculating the CARs measures. Market returns are the equally weighted returns for all common stocks traded on the Shenzhen and Shanghai Stock Exchanges. In total, 790 firms are used for computing the CARs. The accounting return measures are the change in return on sales (ROS), sales growth, and earnings growth. The change in ROS is measured as the difference between the average annual ROS of the three years after the IPO and that of the three years before the IPO year. The sales (earnings) growth variables are the growth rates of sales (earnings) from the average annual sales (earnings) of the three years before the IPO year to that after the IPO year. Due to missing values, 774 observations are used for calculating the statistics of the change in ROS and earnings growth, while 782 observations are used for the sales growth measure. Test statistics for the differences in means and medians are provided. ***, **, and * denote significance at the 1%, 5%, and 10% level, respectively.

Performance measure	Mean				Median			
	Total sample	CEO is politically connected	CEO is not politically connected	Difference in mean	Total sample	CEO is politically connected	CEO is not politically connected	Difference in median
CAR one year after IPO	-1.89*	-7.31	0.07	-7.38***	-7.64***	-14.08	-4.77	-9.31***
CAR two years after IPO	-5.14***	-13.64	-2.04	-11.6***	-13.21***	-18.86	-11.03	-7.83***
CAR three years after IPO	-16.57***	-29.62	-11.81	-17.81***	-20.62***	-30.13	-17.92	-12.21***
Change in ROS	-4.23***	-5.34	-3.83	-1.51*	-1.88***	-1.98	-1.80	-0.18
Growth in sales	105.7***	85.9	113	-27.1***	70.9***	54.5	77.3	-22.8***
Growth in earnings	88.9***	66.9	97.0	-30.1**	55.6***	38.8	62.4	-23.6**

politically connected. Consistent with Figs. 1 and 2, the mean and median CARs decreased significantly over time. In each of the three post-IPO years, the mean and median CARs

of firms with politically connected CEOs were statistically significantly lower than those without politically connected CEOs, indicating that the market was able to distinguish

Table 3 Regression results of the effects of politically connected CEOs on the post-IPO stock performance of newly partially privatized firms in China

The dependent variable reported in this table is stock performance, measured alternately as the cumulative market-adjusted stock returns (CARs) accumulated for 12, 24, and 36 months, starting from one month after the IPO month. Monthly stock returns are used for calculating the CARs measures. Market returns are the equally weighted returns for all common stocks traded on the Shenzhen and Shanghai Stock Exchanges. The independent variables, measured upon the IPO year, include a dummy variable equal to one if the CEO is politically connected (zero otherwise), the percentage ownership of the largest owner, the market-to-book equity ratio, the leverage ratio measured as total debt over sales, the natural log of total assets, and a dummy variable equal to one if the firm is in a heavily regulated sector (natural resources, public utilities, or finance and real estate). The regressions utilize the ordinary least squares method. Absolute values of robust t-statistics are in parentheses. ***, **, and * denote significance at the 1%, 5%, and 10% level, respectively, public during 1993 to 2001.

	CAR one year after IPO	CAR two years after IPO	CAR three years after IPO
CEO is politically connected	-0.069 (2.87)***	-0.099 (2.73)***	-0.153 (3.40)***
Largest shareholder's ownership %	-0.000 (0.14)	-0.000 (0.08)	0.001 (1.07)
Market-to-book of equity	0.109 (10.05)***	0.089 (5.21)***	0.032 (1.59)
Leverage	0.012 (0.73)	0.002 (0.07)	-0.054 (1.72)*
Log of total assets	0.049 (2.86)***	-0.049 (1.86)*	-0.133 (3.96)***
Regulated industry	0.095 (2.90)***	0.132 (2.69)***	0.196 (3.41)***
Constant	-1.330 (3.59)***	0.760 (1.35)	2.633 (3.62)***
Observations	790	790	790
Adjusted R-square	0.18	0.11	0.09

between the two groups of firms within the first year after the IPO. Moreover, the difference in the CARs between the two

groups grew larger each year, suggesting that over the years the market gradually learns more about the negative effects of government intervention.

As for the operating measures of performance, the growth in post-IPO sales and earnings was quite substantial, averaging 106% for sales and 89% for earnings relative to the pre-IPO period. However, the mean (median) change in the three-year average ROS of the full sample was -4.23% (-1.88%), which corroborates the post-IPO decline in stock values.¹⁵ Moreover, our between-group comparison shows that firms led by politically connected CEOs experienced more substantial drops in ROS and slower sales and earnings growth than did their politically unconnected counterparts.

“Multivariate” Regression Analysis and Implications

We next performed a series of regression analyses designed to examine the effects of the CEO’s political connections on post-IPO firm performance. Table 3 presents the results of our ordinary least squares (OLS) regressions using the one-, two-, and three-year CARs as dependent variables. On the right-hand side of the regressions, we include a dummy variable equal to one if the CEO is politically connected. We also included a few control variables: the fraction of common shares held by the largest shareholder (typically a government); the market-to-book equity ratio; the debt-to-sales ratio; the log of total assets; and the regulated industry dummy variable. The ownership variable controls for the possibility that a politician’s rent-seeking incentives depend on the controlling shareholder’s ownership stake in the firm.

Consistent with the “univariate” results reported in Table 2, the multivariate regression results show that firms with politically connected CEOs experience a more statistically significant stock performance decline after the IPO.¹⁶ The results show that firms with politically connected CEOs underperformed those without politically connected CEOs by 7% one year after the IPO, 10% two years after the IPO, and 15% three years after the IPO.

Table 4 presents the results of OLS regressions that analyze the effects of politically connected CEOs on post-IPO changes in operating performance.¹⁷ The regression results show that firms with politically connected CEOs experience deteriorating operating performance after their IPOs, regardless of whether performance is measured by sales growth, earnings growth, or the change in ROS. The difference in the accounting variable is around -1.6% for the change in ROS, -21% for sales growth and -24% for earnings

15. This decline in operating performance of the IPO firms in China is consistent with data reported by Aharoni, Lee, and Wong (2000) and Sun and Tong (2003)

16. We also calculate annual CARs and run the regressions on the pooled post-IPO annual data adjusting for clustering effects (Peterson, 2005). The estimated coefficient of the CEO’s political connections is -0.055 with a t-statistic of 2.84. The magnitudes of the differences in CAR between these two subsamples are similar to the univariate results even after controlling for firm-specific factors that could affect post-IPO stock return performance.

17. The dependent variables are sales growth, earnings growth, and the change in ROS. The independent variables are the dummy variable for a politically connected CEO, the fraction of common shares held by the largest shareholder, the market-to-book equity ratio, the debt-to-sales ratio, the log of total assets, and a regulated industry dummy variable. The top and bottom 5% extreme values are winsorized for the dependent and independent variables in the model.

Table 4 Regression results of the effects of politically connected CEOs on the post-IPO accounting performance of newly partially privatized firms in China

The dependent variable in this table is, alternately, change in ROS, sales growth, and earnings growth. The change in ROS variable is measured as the difference between the average annual ROS of the three years after the IPO and that of the three years before the IPO. The sales (earnings) growth variables are the growth rates of sales (earnings) from the average annual sales (earnings) of the three years before the IPO year to that of the three years after the IPO year. The independent variables, measured upon the IPO year, include a dummy variable equal to one if the CEO is politically connected (zero otherwise), the percentage ownership of the largest owner, the market-to-book equity ratio, the leverage ratio measured as total debt over sales, the natural log of total assets, and a dummy variable equal to one if the firm is in a heavily regulated sector (natural resources, public utilities, or finance and real estate). The regressions utilize the ordinary least squares method. Absolute values of robust t-statistics are in parentheses. ***, **, and * denote significance at the 1%, 5%, and 10% level, respectively.

	Change in ROS	Growth in sales	Growth in earnings
CEO is politically connected	-0.016 (1.94)*	-0.208 (2.35)**	-0.238 (1.89)*
Largest shareholder's ownership %	0.000 (2.30)**	-0.004 (1.98)**	-0.001 (0.55)
Leverage	-0.037 (6.87)***	0.041 (0.57)	-0.209 (2.51)**
Market-to-book of equity	-0.000 (0.11)	0.306 (7.41)***	0.297 (5.97)***
Log of total assets	0.001 (0.10)	0.123 (1.96)*	-0.070 (0.79)
Regulated industry	0.017 (1.60)	0.212 (1.62)	0.716 (4.49)***
Constant	-0.052 (0.42)	-1.809 (1.33)	1.493 (0.79)
Observations	774	782	774
Adjusted R-square	0.08	0.12	0.19

18. We alternatively perform random and fixed-effect regressions based on firm-year panel data for the sample firms from three years before to three years after their IPOs, excluding the IPO years. The dependent variables are accounting performance levels (ROS, log sales level, and log net income level). In addition to our other independent variables, we include a post-IPO dummy variable equal to one if an observation is from the post-IPO period and an interaction term for the CEO's political connection dummy variable and the post-IPO dummy variable. We find that the estimated coefficients of the post-IPO dummy variable are significantly negative, suggesting declined accounting performance after the firms' IPOs. Moreover, the coefficients of the interaction term are

growth. These results are consistent with the univariate results reported in Table 2.¹⁸

To examine if our results are driven by earnings reversals resulting from earnings manipulation during the year of the IPO, we repeated the earnings growth regression reported in Table 4 using operating earnings, which are less subject to manipulation, rather than net earnings in the calculation of ROS and earnings growth. The coefficient of the CEO's political connections remains significantly negative, suggesting that our results are unlikely to be driven by pre-IPO accounting manipulations.

In sum, the regression results in Tables 3 and 4 suggest that partially privatized firms in China generally have poorer stock returns and accounting performance when their CEOs are politically connected through their former or current government or military positions.

Checking for Endogeneity Problems

We were concerned about potential endogeneity issues in the relations between post-IPO performance and the CEO's political connections. A firm's performance and its CEO's political status could both be affected by the firm's local institutional conditions, creating a spurious relation between them. Specifically, regions with poor economic conditions or facing severe unemployment or fiscal problems could have poorly performing firms, creating stronger incentives on the part of local governments to intervene by appointing bureaucrats to run the firms. Moreover, a firm performing poorly prior to its IPO might be likely to recruit a politically connected CEO to facilitate its new share issuance, and then continue to perform poorly after the IPO.

To investigate this endogeneity concern, we re-ran the three-year CAR regressions (as in Table 3) on subsamples that were alternately stratified by firm and regional institutional factors to examine whether the predicted relations persist in the subsample regressions.¹⁹

As reported in Table 5, the findings of our subsample regressions suggest that companies with politically connected CEOs are associated with significantly negative post-IPO CARs regardless of whether they are from regions with high or low GDP per capita, healthy or poor fiscal conditions, or high or low employment rates, or whether they have high or low ROS. The sub-sample regression results thus corroborate the results in Table 3, providing support for the argument that the negative relations between firms' political ties and their post-IPO stock return performance are robust to potential endogeneity.

negative and significant in the ROS and sales regressions, suggesting that politically connected CEOs have a further negative effect on post-IPO accounting performance. These results are not reported in a table but are available upon request.

19. We partitioned the sample by the sample median value of 1) local (provincial) GDP per capita, 2) local fiscal deficit levels, 3) local unemployment rates, and 4) firm return on sales (ROS). The values of each of the regional and firm ROS variables corresponding to an IPO firm are calculated as three-year average values during the three years prior to the firm's IPO. Endogeneity would be a concern if we did not find the relation between the CAR and the CEO's political ties in both of the subsamples.

Table 5 **Regression results of the effects of politically connected CEOs on the post-IPO stock performance of newly partially privatized firms in China using stratified subsamples**

This table reports the results of stock performance regressions on subsamples alternately stratified by firm and regional institutional factors. The sample is partitioned alternately by the sample median value of local (provincial) GDP per capita, local fiscal deficit, local unemployment rate, and firm return on sales (ROS). The values of each of the regional and firm ROS variables corresponding to an IPO firm are calculated as the three-year average values for the three years prior to the firm's IPO. The dependent variable is stock performance, measured as the three-year cumulative market-adjusted stock return (CAR). The stock returns are accumulated for 36 months, starting from one month after the IPO month. Monthly stock returns are used for calculating the CARs. Market returns are the equally weighted returns for all common stocks traded on the Shenzhen and Shanghai Stock Exchanges. The independent variables, measured upon the IPO year, include a dummy variable equal to one if the CEO is politically connected (zero otherwise), the percentage ownership of the largest owner, the market-to-book equity ratio, the leverage ratio measured as total debt over sales, the natural log of total assets, and a dummy variable equal to one if the firm is in a heavily regulated sector (natural resources, public utilities, or finance and real estate). The regressions utilize the ordinary least squares method. Absolute values of robust t-statistics are in parentheses. ***, **, and * denote significance at the 1%, 5%, and 10% level, respectively.

	GDP per capita		Fiscal deficit		Unemployment rate		ROS	
	Low	High	Low	High	Low	High	Low	High
CEO is politically connected	-0.149 (2.30)**	-0.223 (3.60)***	-0.155 (2.35)**	-0.127 (2.06)**	-0.152 (2.15)**	-0.147 (2.55)**	-0.132 (2.17)**	-0.185 (2.72)***
Largest shareholder's ownership %	0.001 (0.66)	0.002 (1.24)	0.002 (1.23)	0.000 (0.18)	-0.001 (0.58)	0.003 (2.13)**	-0.001 (0.46)	0.002 (1.67)*
Market-to-book of equity	0.005 (0.16)	0.068 (2.59)***	-0.001 (0.04)	0.089 (2.82)***	0.025 (0.81)	0.048 (1.68)*	0.003 (0.10)	0.069 (2.19)**
Leverage	-0.091 (1.69)*	-0.037 (0.96)	-0.094 (2.29)**	0.027 (0.57)	-0.083 (1.77)*	-0.030 (0.72)	-0.153 (3.03)***	-0.003 (0.07)
Log of total assets	-0.218 (4.40)***	-0.062 (1.47)	-0.194 (4.27)***	-0.030 (0.58)	-0.139 (2.93)***	-0.127 (2.58)**	-0.217 (4.94)***	-0.069 (1.26)
Regulated industry	0.227 (2.69)***	0.157 (1.94)*	0.407 (4.44)***	-0.036 (0.52)	0.148 (1.60)	0.208 (2.88)***	0.305 (2.51)**	0.144 (2.11)**
Constant	4.530 (4.28)***	1.000 (1.09)	3.729 (3.85)***	0.354 (0.31)	2.953 (2.86)***	2.310 (2.19)**	4.655 (4.84)***	1.044 (0.89)
Observations	389	396	390	395	392	393	391	391
Adjusted R-square	0.12	0.15	0.10	0.09	0.08	0.10	0.12	0.08

When Do the Valuation Effects of Political Connections Show Up?

We also investigated how soon after the first public trading day the stock market begins to capture the effects of the political connections of a firm's CEO by examining the daily stock return patterns in the first 60 days of trading, starting from the second day after the IPO. We then focused on the initial (first-day) stock return pattern of the IPO firms.

Fig. 3 plots the mean daily CAR of the sample firms from the first day to the 60th day subsequent to the initial trading day. As shown in the figure, the mean CAR drops

by almost 4% within the first 60 days after IPO, excluding the initial day of trading. When we divide the sample based on the CEO's political ties, as shown in Fig. 4, the politically connected firms start to underperform their politically unconnected counterparts around 13 to 14 days after the IPO. The difference in the mean CAR between the two groups of firms widens over time to about 4.4% by the 60th day.²⁰ Consistent with Fig. 4, the regression results suggest that the negative impact of the CEO's political connections grows over time, from 0.6% in the first 20 days to 4% by the 60th day. These results indicate that the firms led by

20. To test whether the short-term CAR difference between the two groups is significant and robust to other influencing factors, we run the same regressions reported in Table 3, but alternately using CARs 20 days, 40 days, and 60 days after the initial trading day as dependent variables. The coefficient on the CEO's connection dummy is nega-

tive but insignificant in the 20-day CAR regression, but it is negative and significant in the 40-day CAR regression (10% significance level) and in the 60-day CAR regression (5% significance level).

Figure 3

Mean post-IPO cumulative market-adjusted compound stock returns (CARs) from one to 60 days after the initial trading day of 790 partially privatized firms in China that went public during 1993 to 2001.

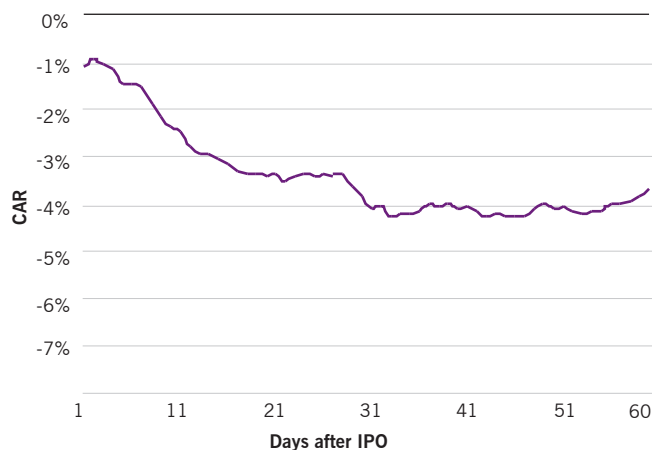
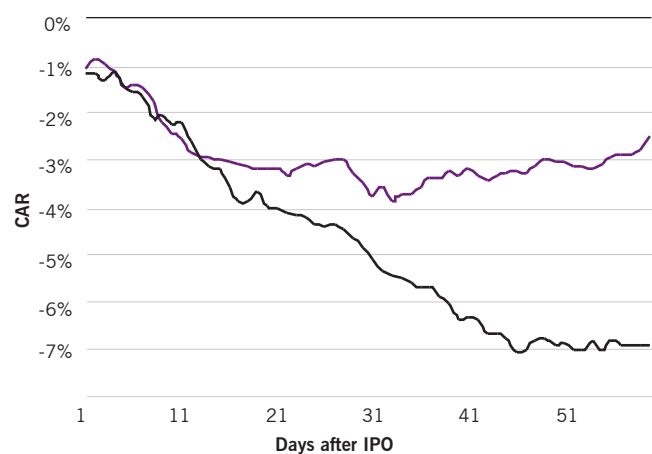


Figure 4

Mean post-IPO cumulative market-adjusted compound stock returns (CARs) from one to 60 days after the initial trading day of 790 partially privatized firms in China that went public during 1993 to 2001, sorted by whether their CEOs are current or former government bureaucrats.



politically connected CEOs significantly underperform their politically unconnected counterparts beginning shortly after their IPOs.

We next included additional control variables, based on prior studies of Chinese IPOs.²¹ Information asymmetry among the issuer, the underwriter, and investors could lead to underpricing of IPO shares.²² We included issue size (the natural logarithm of the number of shares issued) to capture the effects of information asymmetry. Initial returns are expected to be higher from a smaller share issue. As an additional control of information asymmetry, we included the natural logarithm of the number of days between the offering date and the listing date, because information asymmetry tends to be more severe when a longer time elapses between the offering date and the listing date. China's IPOs are often characterized by long such time lags.

Finally, we included the largest shareholder's ownership percentage to control for the effects of non-tradable shares and state control. The ex ante relation between the ownership variable and the initial return is ambiguous. One potential effect of the high concentration of ownership in government hands is that there are too few tradable shares to satisfy market demand, hence causing high initial returns. Another effect could be that investors discount the stock (and hence there are low initial returns) because they anticipate the association between a high concentration of state ownership

and low firm productivity.

As we expected, several control factors appear to have influenced an IPO's initial returns. When the time lapse between the offering and listing day was longer, and when the issue size was smaller, the initial returns were higher. The estimated coefficient on the largest shareholder's ownership percentage was significantly negative, suggesting that IPO stock investors discount the value of new issues when the state retains a large non-tradable ownership block. Nonetheless, the coefficient of the CEO's political connection dummy variable remained negative and significant at the 10% level. The marginally lower initial return, or smaller underpricing, associated with a politically connected CEO is consistent with the signaling argument that non-interventionist governments underprice IPO shares to signal their credible intention of relinquishing control of the firms.

Effects on Board Composition

Finally, we examined the board structures of IPO firms in China, and how the government's rent extraction incentive might affect the degree of professionalism and the monitoring function of the boards. We constructed several variables to capture the governance and the degree of professionalism of the sample firms' boards of directors. The mean statistics of the full sample reveal that a typical corporate board in China has about nine directors (excluding the CEO), 24% of whom

21. (Su and Fleisher, 1999; Chan, Wang, and Wei, 2004; Chen, Firth, and Kim, 2004).

22. (see, e.g., Baron, 1982; Rock, 1986).

Table 6 Regression results of the effects of different types of political connections of the CEO on the post-IPO stock performance of newly partially privatized firms in China

The dependent variable in this table is stock performance, measured alternately as the cumulative market-adjusted stock return (CAR) cumulated for 12, 24, and 36 months starting from one month after the IPO month. Monthly stock returns are used for calculating the CARs measures. Market returns are the equally weighted returns for all common stocks traded on the Shenzhen and Shanghai Stock Exchanges. The independent variables, measured upon the IPO year, include three dummy variables for political connection that equal one if alternately 1) the CEO is connected with a local government governing the firm's region, 2) the CEO is connected with the central government, and 3) the CEO is connected with a local government outside the firm's geographic region, respectively. Other variables are the percentage ownership of the largest owner, the market-to-book equity ratio, the leverage ratio measured as total debt over sales, the natural log of total assets, and a dummy variable equal to one if the firm is in a heavily regulated sector (natural resources, public utilities, or finance and real estate). The regressions utilize the ordinary least squares method. Absolute values of robust t-statistics are in parentheses. ***, **, and * denote significance at the 1%, 5%, and 10% level, respectively.

	CAR one year after IPO	CAR two years after IPO	CAR three years after IPO
CEO is connected with a local government of the same region	-0.051 (1.84)*	-0.090 (2.16)**	-0.135 (2.51)**
CEO is connected with the central government	-0.112 (1.65)*	-0.241 (2.35)**	-0.285 (2.16)**
CEO is connected with a local government of a different region	-0.084 (1.97)**	-0.056 (0.87)	-0.136 (1.64)
Largest shareholder's ownership %	-0.000 (0.14)	-0.000 (0.19)	0.001 (1.06)
Market-to-book of equity	0.108 (11.34)***	0.088 (6.07)***	0.031 (1.67)*
Leverage	0.012 (0.74)	0.002 (0.09)	-0.054 (1.73)*
Log of total assets	0.049 (2.91)***	-0.048 (1.91)*	-0.134 (4.13)***
Regulated industry	0.097 (3.16)***	0.138 (2.96)***	0.202 (3.39)***
Constant	-1.315 (3.68)***	0.753 (1.39)	2.641 (3.80)***
Observations	790	790	790
Adjusted R-square	0.18	0.11	0.09

23. See, for example, Hermalin and Weisbach (1988) and Yermack (1996).

24. Farrell and Hersch (2001) document that the percentage of women on the board of Fortune 1000 firms was less than 2% from 1990 to 1999. As reported in Appendix 2, female directors are negatively correlated with the presence of politically connected CEO (-10%) and politically connected directors (-12%), while positively correlated with

are current or former government bureaucrats and 33% of whom are senior managers of the company.

Forty-three percent of the board members are professional managers. Their backgrounds are in unaffiliated businesses; in accounting, law, or finance; or in academic institutions. Only 24% of the directors had current or previous experience in unaffiliated companies. This percentage is rather small relative to boards of U.S. firms, which are typically dominated by outside directors with professional qualifications.²³ Accountants, lawyers, or directors with prior experience in financial institutions or securities intermediaries constitute only 6% of the board. By contrast, there is a surprisingly large percentage (mean 14%) of directors with academic backgrounds. The board is young (mean age of 47) and the average education level of the directors is low (between junior college and college). Compared with boards of U.S. firms, there is a higher percentage (6%) of female directors.²⁴ There was almost no director representing minority shareholders during our sample period, be they institutional or individual investors.

Our study showed that when a CEO is politically connected, it is highly likely that his or her political allies are also on the board. Moreover, CEOs' political connections are associated with low professionalism on boards: the difference in both the mean and median percentage of professionals was significantly smaller for the group of firms led by politically connected CEOs. When a CEO is politically connected, his or her firm had fewer directors with business experience from unaffiliated firms, fewer academicians and women serving as directors, and older directors on average. The firm also had fewer directors with experience in accounting, finance, or law, but the difference is statistically insignificant. The directors' education levels were also higher for firms with politically connected CEOs, but the differences are not statistically significant.

Conclusion

Our study provides suggestive evidence of the negative effects of politically connected CEOs on the corporate performance and governance of publicly listed companies in China. Newly listed Chinese companies with politically connected CEOs are more likely to have boards that are populated by current or former government bureaucrats, and that generally exhibit low degrees of professionalism, as indicated by fewer directors with relevant professional backgrounds. At the same time, the operating and stock-return performance of the firms run by politically connected CEOs has failed to match that of their politically unconnected counterparts.

In sum, our study provides more support for the argument that bureaucrats and politicians extract resources

directors possessing business experience from unaffiliated firms (19%) and directors with legal, accounting, or finance expertise (24%). These gender statistics suggest that women are more likely appointed to boards for their specialized expertise than for their managerial or political roles. Similarly, Agrawal and Knoeber (2001) find that female directors do not play a political role in the U.S.

from listed SOEs under their control to fulfill objectives that are not consistent with firm value maximization. Expressed in more general terms, the main finding of our study is that the constraints on property rights faced by Chinese SOEs—namely the non-transferability of state ownership and the right of the government to appoint CEOs—appear to have significantly negative effects on firm performance as well as board professionalism and governance. Removing these constraints will likely have to be a critical part of any future reforms that aim to improve the productivity of listed Chinese companies.

But does this rule out the possibility that stock markets could play an effective role in monitoring corporate management even if the government remains the controlling owner of privatized firms? The evidence in support of this possibility is mixed.²⁵ Unlike India and the U.S., China did not have a well-established stock market that pre-dates its partial privatization. And the agency conflicts between bureaucrats/politicians and minority shareholders that are the main focus of our study would appear to be a major (if not the most important) contributor to the general post-IPO underperformance of China's SOEs.

Perhaps most important, we believe that our findings about China's companies could be instructive for emerging economies around the world that have weak legal systems and

limited property rights. Such countries can learn from the experience of China's partial privatization that a government's reluctance to relinquish even just a subset of its property rights with regard to its enterprises can have significantly negative consequences on corporate governance and firm performance.

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25. Prior literature provides mixed evidence. Based on a developing country sample, Boubakri, Cosset, and Guedhami (2005) report that post-privatization firm performance is positively related to the degree to which the government relinquishes control. However, a parallel study of developed countries by D'Souza, Megginson, and Nash (2005) finds that state ownership is associated with reduced employment and increased capital spending after privatization. Kole and Mulherin (1997) examine a sample of U.S. firms

with substantial ownership under federal government custody during and after World War II. Consistent with the market monitoring view, they report that the performance of the government-controlled firms is not significantly different from private-sector firms in the same industry. Gupta (2005) finds that partial privatization in India is associated with improvement in firm profitability.