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Empirical research on the effect of top management team's political connection on enterprise value in China's private listed companies

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ABSTRACT

In this paper, the problems to be solved are whether top management team's political connection have effects on enterprise value in China Private Listed Companies. The significance of solving such problems is that enriching the domestic research theoretically and improving corporate governance practically. The core innovation in this research is that we classify the differences between central political connection and local political connection. The new part compared with previous work is that we summarize the way in which political connection affects corporate value through the analysis of a series of economic phenomena brought by political connection. Based on the above analysis, we get the hypothesis of this paper. To verify the proposed hypothesis of this paper, we select 1067 private listed companies as samples to research on and we get some significant conclusions: (1) Political connection have positive effect on the enterprise value of private listed companies; (2) Central political connection's effect is more obvious than the local political connection on the enterprise value; (3) The higher the proportion of politically connected executives, the better enterprise value in private listed companies.

KEYWORDS

Top management team; Political connection; Enterprise value; Private listed company.



INTRODUCTION

As the market is not fully effective, so the rent-seeking phenomenon is widespread. In order to get more policy support, enterprises will do everything possible to establish political connection with governmental officials. Political connection is one of the links between internal governance and external governance. In recent years the research of political connection is attracting more and more attention of the scholars at home and abroad. Political connection is of greater significance and practical value for the business operations and management. However, the study of political connection started late in China, our country's political connection study is dependent on the abroad study of political connection. Chinese scholars should combine the research of political connection with China's national conditions and apply the research to the country's economic practice to get further research and innovation^[1].

In this paper, political connection is defined as the top management team (including president, vice president, chief financial officer) disclosed in corporate annual reports are government officials, deputies, CPPCC members, or army officers in central government or local government now or ever^[2].

THE THEORETICAL ANALYSIS AND HYPOTHESES

The paths of political connection's impact on enterprise value

Top management team's political connection can bring a range of economic phenomena and affect the enterprise value ultimately. In this paper, the main pathways of political connection's impact on enterprise value are summarized on the basis of a lot of reading on the relevant literature. Specifically, the main paths are the following.

(1) Debt financing

Mian and Khwaja (2006) selected more than 90000 Pakistani companies between 1996-2002 as study samples and found that the government-backed companies received more than 45% of the loans than the no government-backed companies^[3]. Charumilind et al. (2006) studied in the Thailand companies and found that politically connected companies are easier to apply for long-term mortgages from bank than other companies^[4].

Similarly, Zhongqin Su et al. (2012) found that there is a negative correlation between the political connection and equity cost through an empirical study on Chinese enterprises and investors demand a lower risk premium for politically connected enterprises^[5].

(2) Shares

Goldman (2006) found the stock returns of the companies related with Republican Party were significantly higher than the Democratic Party when Republican Party won in the U.S. presidential election^[6]. HUANG Xin-jun and TANG Liang-xia (2012) confirmed that the politically connected companies can get more raised funds than the nonpolitical connected companies in the IPO of China's listed companies^[7]. CAI Wei-Xing, Hu Zhi-Ying, HE Feng (2013) selected the 2009-2011 GEM listed companies as samples and concluded that the politically connected company can be more easily to get the chance for IPO compared to nonpolitically connected company^[8].

(3) Diversification and trade barriers

Luo Dangling and Tang Qingquan (2009) thought politically connected private company is more likely to break trade barriers and obtain policy support and government subsidy in China^[9]. Xia Lijun et al. (2011) confirmed that the political connection of company executives of companies controlled by local governments can encourage enterprises to open subsidiaries, branches or joint ventures^[10].

(4) Financial subsidies and tax incentives

Yu Minggui et al (2010) studied on the financial data of China's private listed companies, and

found that the politically connected private companies get more financial subsidies from government compared to non-politically connected private companies^[11]. Danglun Luo and Zhu Wei (2012) found that there was a significant positive correlation between the degree of private enterprises' political connection and the degree of tax avoidance^[12].

In addition to the above, there are also other economic phenomenon affected by political connection, such as R&D investment, social welfare activities, accounting information disclosure, protection of property rights and top management turnover, etc. It is through these pathways that the political connection affects enterprise value ultimately.

THE HYPOTHESIS

First of all, it can be concluded that political connection can bring a range of benefits for the enterprise and improve the business situation of the enterprises. So the first hypothesis (H1) is proposed as the following.

H1: Top management team's political connection is significantly positively correlated with the enterprise value in China's private listed companies.

Secondly, there is a big difference between China's central government and local governments in terms of the behavior and the profit motive. The central government is in the dominant place in the securities market. The central government can restrict the behavior of the local government through some administrative measures. So the second hypothesis (H2) is proposed as the following.

H2: Top management team's political connection with central government has a greater significantly positive impact on the enterprise value than top management team's political connection with local government.

Accordingly, the higher proportion of politically connected members in top management team correlates the higher level of political connection positively and indicates the enterprise is closely related to the government. So the third hypothesis (H3) is proposed as the following.

H3: The enterprise value and the proportion of politically connected members in top management team are positively correlated.

THE RESEARCH DESIGN

Sample and data

This paper selected 1067 private listed companies as the research sample from Shanghai stock exchange and Shenzhen stock exchange in 2010 to 2012. In order to achieve the purpose of this study, three principles were followed strictly during the data's collecting. Firstly, this article excludes the data of ST companies to make the research to be general and representative. Secondly, the private listed companies lacking of executives' information were removed out so as to make the research rigorously and reliably. Thirdly, the paper also removed the financial enterprises because of the particularity of financial enterprises' financial indicators.

Variable definitions

The definitions for dependent variable, independent variables, and control variables are shown in TABLE 1.

EMPIRICAL MODEL

In order to verify the hypotheses, the following models are set, and then we use SPSS software to carry out linear regression analyses.

Model 1: $Tobin_Q = \beta_1 + \beta_2 Pol + \beta_3 Top1 + \beta_4 Asset + \beta_5 Lev + \beta_6 Grow + \beta_7 Industry + \beta_8 Year + \mu$

Model 2: $Tobin_Q = \beta_1 + \beta_2 Pol_loc + \beta_3 Top1 + \beta_4 Asset + \beta_5 Lev + \beta_6 Grow + \beta_7 Industry + \beta_8 Year + \mu$

Model 3: $Tobin_Q = \beta_1 + \beta_2 Pol_loc + \beta_3 Pol_cen + \beta_4 Top1 + \beta_5 Asset + \beta_6 Lev + \beta_7 Grow + \beta_8 Industry + \beta_9 Year + \mu$

Model 4: $Tobin_Q = \beta_1 + \beta_2 Loc_cen + \beta_3 Top1 + \beta_4 Asset + \beta_5 Lev + \beta_6 Grow + \beta_7 Industry + \beta_8 Year + \mu$

Model 5: $Tobin_Q = \beta_1 + \beta_2 Pol_ratio + \beta_3 Top1 + \beta_4 Asset + \beta_5 Lev + \beta_6 Grow + \beta_7 Industry + \beta_8 Year + \mu$

Model 1 is used to verify H1. If the coefficient in front of Pol in the regression equation is positive and significant, it means that top management team’s political connection is significantly positively correlated with the enterprise value in China’s private listed companies. The impact of political connection on enterprise value is analyzed in general and we don’t distinguish between the local government political connection and the central government political connection.

TABLE 1 : Variable definitions

| | Abbreviation | Definitions |
|--|--------------|---|
| Dependent Variable | | |
| Enterprise Value | Tobin_Q | Tobin_Q = (The number of shares in circulation*Share price + The number of non-tradable shares*Net assets per share + The carrying value of liabilities)/ Total assets |
| Variables | | |
| Political Connection | Pol | If the top management team is politically connected, Pol=1, if not, Pol=0. |
| Local Political Connection | Pol_loc | If the top management team is politically connected to local government, Pol_loc=1, if not, Pol_loc =0. |
| Central Political Connection | Pol_cen | If the top management team is politically connected to central government, Pol_cen=1, if not, Pol_cen =0. |
| Local and Central Political Connection | Loc_cen | If the top management team is politically connected to local government and no central government, Loc_cen=1. If the top management team is politically connected to central government and no local government, Loc_cen= -1. Otherwise, Loc_cen=0. |
| The Ratio of Politically Connected Members | Pol_ratio | Pol_ratio= The amount of politically connected members in top management team / The amount of all members in top management team |
| Control Variables | | |
| Shareholding Structure | Top1 | The proportion of the largest shareholder |
| Firm size | Asset | Natural logarithm of total assets |
| asset-liability ratio | Lev | Lev = Total Liabilities / Total Assets |
| The main business revenue growth | Grow | Main business revenue growth= (Current main business income- Last main business income)/ Last main business income |
| Industry dummy variables | Industry | If in the set industry, the value is 1,otherwise the value is 0 |
| Year dummy variables | Year | If in the set year, the value is 1,otherwise the value is 0 |

Model 2, Model 3 and Model 4 is used to verify H2. If the coefficient in front of the Loc_cen in the regression equation is negative and significant, it shows the impact of central government political connection on the enterprise value is greater than the impact of local government political connection. In the contrast, if the coefficient in front of the Loc_cen in the regression equation is positive and significant, it shows the impact of local government political connection on the enterprise value is greater than the impact of central government political connection. If the coefficient in front of the

Loc_cen in the regression equation is not significant, it shows there is no significant difference between local government political connection and central government political connection.

Model 5 is used to verify H3. If the coefficient in front of Pol_ratio is positive and significant, it shows the enterprise value and the proportion of politically connected members in top management team are positively correlated. If the coefficient in front of Pol_ratio is negative and significant, it shows the enterprise value and the proportion of politically connected members in top management team are negatively correlated.

EMPIRICAL ANALYSIS

Variable descriptive statistics

As can be seen from TABLE 2, the mean of China's private listed companies' Tobin_Q is 2.0807, the median is 1.9415, the minimum is 0.1620 and the maximum is 7.3625. The maximum is about 45 times that of the minimum. The difference between maximum and minimum is 7.2005 and that means the visible differences among private listed companies' Tobin_Q is quite great. However, the standard deviation is only 0.1924 on the whole and it indicates that the phenomenon is caused only by a minority of companies.

TABLE 2 : Variable descriptive statistics

| Variables | N | Mean | Median | Min | Max | Std. Dev. |
|-----------|------|---------|---------|---------|-----------|-----------|
| Tobin_Q | 1067 | 2.0807 | 1.9415 | 0.1620 | 7.3625 | 0.1924 |
| Pol | 1067 | 0.4902 | 0.0000 | 0.0000 | 1.0000 | 0.5401 |
| Pol_loc | 1067 | 0.4358 | 0.0000 | 0.0000 | 1.0000 | 0.4930 |
| Pol_cen | 1067 | 0.1106 | 0.0000 | 0.0000 | 1.0000 | 0.2012 |
| Loc_cen | 1067 | 0.2904 | 0.0000 | -1.0000 | 1.0000 | 0.3215 |
| Pol_ratio | 1067 | 0.0837 | 0.0000 | 0.0000 | 0.7273 | 0.0974 |
| Top1 | 1067 | 0.3401 | 0.3028 | 0.0461 | 0.9487 | 0.1951 |
| Asset | 1067 | 21.0459 | 21.0132 | 18.7249 | 21.7595 | 1.3520 |
| Lev | 1067 | 0.4503 | 0.4917 | 0.0705 | 2.6103 | 0.1955 |
| Grow | 1067 | 3.1442 | 0.1809 | -8.9117 | 1678.4323 | 54.1321 |

The mean of Pol is 0.4902, indicating that 49.02% of China's private listed companies has political connection and politically connected executives are widespread in China's private listed companies. Pol_ratio is the short for the ratio of politically connected executives and its mean is 0.0837, however, the ratio of politically connected executives in some companies is as high as 72.73%, which further demonstrates the political connection is prevalent in China's private listed companies.

Comparative analysis of the main variables

As can be seen from TABLE 3, the difference between nonpolitically connected companies and politically connected companies is analyzed. The mean and median of Tobin_Q of politically connected companies are significantly higher than that of nonpolitically connected companies and there is further certification below by linear regression analysis. At the same time, the mean and median of the natural logarithm of politically connected companies' total assets is greater than that of nonpolitically connected companies. On the contrast, the proportion of the largest shareholder, the sum of the proportion of the top three shareholders and the main business revenue growth of nonpolitically connected companies is greater than that of politically connected companies in all. Generally speaking, the more concentrated equity, the weaker equity checks and balances, more large shareholders would violate the interests of

minority shareholders. It is shown in the TABLE 3 that operating performance such as Tobin_Q is negatively correlated with ownership concentration^[13,14].

TABLE 3 : Comparative analysis

| Variables | Mean | | Median | |
|-----------|------------------------------------|---------------------------------|------------------------------------|---------------------------------|
| | nonpolitically connected companies | politically connected companies | nonpolitically connected companies | politically connected companies |
| Tobin_Q | 1.8829 | 2.2864 | 1.7837 | 2.1463 |
| Asset | 20.1329 | 21.9956 | 20.1095 | 21.9517 |
| Top1 | 0.3831 | 0.2954 | 0.3452 | 0.2614 |
| Grow | 3.3569 | 2.9230 | 0.2318 | 0.13087 |

Pearson correlation coefficient analysis

TABLE 4 : Pearson correlation coefficient analysis

| Variable | Pol | Pol_loc | Pol_cen | Loc_cen | Pol_ratio | Top1 | Asset | Lev | Grow |
|-----------|-------|---------|----------|----------|-----------|---------|---------|----------|--------|
| Pol | 1.000 | 0.827** | 0.337** | 0.649** | 0.721** | 0.074** | 0.027 | -0.024 | 0.012 |
| Pol_loc | — | 1.000 | -0.098** | 0.792** | 0.759** | 0.055* | -0.056* | -0.021 | 0.017 |
| Pol_cen | — | — | 1.000 | -0.447** | 0.479** | 0.055* | 0.170* | 0.019 | -0.014 |
| Loc_cen | — | — | — | 1.000 | 0.461** | 0.017 | -0.137* | -0.019 | 0.031 |
| Pol_ratio | — | — | — | — | 1.000 | 0.074* | 0.041 | 0.032 | 0.013 |
| Top1 | — | — | — | — | — | 1.000 | 0.057* | -0.109** | 0.087* |
| Asset | — | — | — | — | — | — | 1.000 | 0.087* | 0.011 |
| Lev | — | — | — | — | — | — | — | 1.000 | 0.035* |
| Grow | — | — | — | — | — | — | — | — | 1.000 |

Notes : All variables are defined in TABLE 1. ** represent significant on the 1% level. * represent significant on the 5% level.

As can be seen from TABLE 4, the person correlation coefficients of Pol and Pol_loc, Pol and Loc_cen, Pol and Pol_ratio, Loc_cen and Pol_loc, Loc_cen and Pol_cen, Pol_ratio and Pol_loc, Pol_ratio and Loc_cen are 0.827, 0.649, 0.721, 0.792, -0.447, 0.759, 0.461, so these variables are put into different linear regression equation models for testing.

Linear regression analysis

As can be seen from TABLE 5, the correlation coefficient of Pol 1 is 0.040 and is significantly positive on the 5% level in Model 1, which verifies the hypothesis H1. It is proved that top management team's political connection is significantly positively correlated with the enterprise value in China's private listed companies. Firm size and enterprise value is significantly negatively correlated on the 10% level and the correlation coefficient is -0.031, indicating that the larger the firm size, the less the enterprise value. Asset-liability ratio and enterprise value is significantly positively correlated on the 1% level and the correlation coefficient is 0.350, indicating that both asset-liability ratio and enterprise value increase and decrease together. The proportion of the largest shareholder and enterprise value is significantly positively correlated on the 10% level and the correlation coefficient is 0.634, indicating that both the proportion of the largest shareholder and enterprise value increase and decrease together.

In Model 2, the correlation coefficient of Pol_loc is 0.023 and is uncorrelated, indicating that top management team's political connection with local government doesn't has a significantly positive impact on the enterprise value. In Model 3, the correlation coefficient of Pol_loc is 0.014 and is also

uncorrelated, which further illustrate that top management team's political connection with local government doesn't has a significantly positive impact on the enterprise value. While the correlation coefficient of Pol_cen is 0.091 and is significantly positive on the 5% level, indicating that top management team's political connection with central government has a significantly positive impact on the enterprise value, too. In model 4, the correlation coefficient of Loc_cen is -0.065 and is uncorrelated, combined with the results of Model 2 and Model 3, it is concluded that top management team's political connection with central government has a greater significantly positive impact on the enterprise value, but H2 can't be verified.

TABLE 5 : Linear regression analysis

| | Model 1 | Model 2 | Model 3 | Model 4 | Model 5 |
|-----------|---------------------|---------------------|---------------------|----------------------|----------------------|
| Constant | 0.673*** (4.705) | 0.683*** (4.937) | 0.686*** (4.985) | 0.681*** (4.421) | 0.673*** (4.310) |
| Pol | 0.040** (1.982) | | | | |
| Pol_loc | | 0.023 (1.584) | 0.014 (1.577) | | |
| Pol_cen | | | 0.091** (2.541) | | |
| Loc_cen | | | | -0.065 (-1.493) | |
| Pol_ratio | | | | | 0.142** (2.258) |
| Top1 | 0.634* (1.814) | 0.646* (1.784) | 0.614* (1.884) | 0.660* (1.801) | 0.606* (1.797) |
| Asset | -0.031* (-1.695) | -0.029* (-1.706) | -0.032* (-1.729) | -0.030* (-1.705) | -0.031* (-1.748) |
| Lev | 0.350*** (2.602) | 0.348** (2.504) | 0.349*** (2.761) | 0.348*** (2.690) | 0.346*** (2.713) |
| Grow | 5.937E-5 (1.598) | 6.091E-5 (1.382) | 6.473E-5 (1.417) | 6.343E-5* (1.709) | 6.400E-5* (1.694) |
| Industry | YES | YES | YES | YES | YES |
| Year | YES | YES | YES | YES | YES |

Notes : All variables are defined in TABLE 1. * represent significant on the 1% level, ** represent significant on the 5% level, * represent significant on the 10% level.**

In model 5, the correlation coefficient of Pol_ratio coefficient is 0.142 and is significantly positive on the 5% level, which indicates that the enterprise value and the proportion of politically connected members in top management team are positively correlated. As the proportion of politically connected members in top management team increases, so the enterprise value decreases. This can be explained by that the enterprise is closely related to the government and can get more policy supports, financial subsidies and tax incentives, etc which can increase enterprise value in return. H3 is verified.

CONCLUSIONS

This study can be summarized in one sentence that top management team's political connection enhances private listed companies' enterprise value in all. Top management team's political connection with central government has a greater significantly positive impact on the private listed companies' enterprise value, however, it can't be verified that top management team's political connection with central government has a greater significantly positive impact on the enterprise value than local government. The enterprise value and the proportion of politically connected members in top

management team are positively correlated. China's private listed companies should handle the relationship with the government well and build political connection with government rationally and legally. Employing new executives who are government officials, deputies, CPPCC members, or army officers in central government or local government now or ever is an effective way to gain political connection with government but not the only way. In the current situation, China's private listed companies are inclined to strive to create a relaxed and harmonious external environment and enable enterprises to gain competitive strengths, policy support, financial subsidies and tax incentives, etc. It will improve the economic efficiency of China's private listed companies in return.

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