

Corporate Pyramid, Ownership Structure, and Firm Performance: Evidence from China

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This paper examines the relationship among corporate pyramid, ownership structure, and firm performance in China. We find a negative effect of corporate pyramid in terms of the length of control chain on the performance of non-state-owned enterprises (NSOEs). That is, the longer the control chain, the greater the agency costs and the worse firm performance. In contrast, the control chain is positively related to the performance of SOEs. In addition, we show that control rights and cash flow rights of state-owned enterprises (SOEs) are significantly larger than that of non-state-owned enterprises, while the divergence of control rights and cash flow rights is more severe for NSOEs. We also find that the relation between the control rights of ultimate shareholders and firm performance is nonlinear. Our empirical results appear to be robust for different control rights.

Keywords: Ultimate shareholder; Government control; Control right; Control chain; Performance

1. Introduction

As the securities market grows, the China Securities Regulatory Commission (CSRC) continues to issue more accounting standards and regulations to standardize the disclosure and reporting of listed companies. For instance, the standards and regulations applied to the IPO, seasoned issue, rights offering, dividend policy, and annual report have improved over time. Before 2000, the transparency of ownership structure was limited. In order to protect the interest of investors and improve corporate governance, the CSRC has required all listed companies to disclose additional information to mitigate information asymmetry between inside and outside investors. On August 2, 2001, the CSRC issued a new standard for information disclosure. The Information Disclosure Content and Format Standard Number 2 -- Annual Report Content and Format requires listed companies to disclose the controlling party and the ultimate shareholder including their names, ownerships, relations with the companies, and other relevant information. Despite the implementation of this standard, the practice of information disclosure was nowhere near what the regulation authority expected. A great number of listed companies still failed to disclose relevant information, including ownership and controlling parties in their annual reports. To remedy the deficiency in information disclosure, the CSRC

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issued a revised version of Number 2 standard on December 22, 2003, requiring all listed companies to disclose their ownership structure trees and relevant information in their annual reports starting from 2004. This supplemental standard not only enhanced the transparency of information disclosure, helping investors to understand the ownership structure between companies and groups, but also provided data for our research, facilitating our investigation of the status quo of the ultimate shareholders in Chinese listed companies. Furthermore, we can examine the effect of the divergence of control right from ownership or cash flow rights on firm performance and valuation.

In this paper, we investigate all ultimate shareholders of listed companies in 2003 and 2004 in Chinese stock markets. Out of the 2,614 listed companies in this period, we have identified the ultimate shareholders of 2,554 companies. The remaining companies have either no ultimate shareholders or ultimate shareholders that could not be identified due to lack of information. In the companies for which we have identified the ultimate shareholders, 1,848 of them (72.36%) are SOEs. The remaining are NSOEs. Control rights, ownership, and control chain are also identified for each company. Control chain refers to the layers of control between the ultimate shareholder and the listed companies. We find that the control rights and ownership of SOEs are significantly greater than those of NSOEs, while the divergence of control rights from cash flow rights is more extreme for NSOEs. Moreover, the average performance, measured by ROA and OROA, is better for SOEs than for NSOEs.

According to the classic principal-agency theory, the greater the convergence of control right and cash flow rights, the less incentive ultimate shareholders will have to expropriate the minority stakeholders and result in better firm performance. We find that the relation between control rights of ultimate shareholders and firm performance is not linear. Specifically, our result exhibits a reversed N shape with turning points at about 27% and 79% ownership. The result from a piece-wisely regression is consistent with the above finding. As the control rights of ultimate shareholders increase, firm performance first descends and then ascends. Beyond a maximum level, inefficiency emerges and performance declines. This conclusion holds true for operation performance, namely OROA; earnings management will erode our results. Control chain has a negative effect for NSOEs, since longer agency levels imply greater agency costs. Ultimate shareholders will not exert enough effort to manage the listed companies, resulting in unsatisfactory performance. By contrast, the control chain is positively related to the performance of SOEs. The performance of companies controlled by individuals is not as good as those controlled by other legal entities such as institutional investors due to the fact that institutional investors may have better discipline and monitoring, while individuals are not.

This paper contributes to the literature in two ways. First, this paper investigates the ultimate shareholders in the fast growing emerging market, China, which is very different from those in well-developed markets. As increasing numbers of Chinese companies are listed in the U.S., U.K. and Hong Kong, global investors are very concerned about the corporate governance issue of Chinese companies. Unlike other studies, this paper uses the data of ultimate shareholders and corporate pyramid