When do controlling shareholders expropriate?

Controlling shareholder performance and cash transfer tunneling from listed firms in China

- Cheung, Rau, Stouraitis, Tan

Discussion by

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What does this paper study?

- Try to understand incentives driving expropriation by controlling shareholders
- **When** do controlling shareholders engage in tunneling activity?
  - Usual problem in answering this question: No data/information on controlling shareholder
  - Variation in incentives of the controlling shareholder to expropriate not observable
- In China most publicly listed firms have a non-listed State Owned Enterprise (SOE) as the largest shareholder (parent), whose operating performance in observable

Main results

- The incentive to tunnel resources out of the publicly listed subsidiary is higher when the parent is underperforming
- When the parent is underperforming… we see
  - Higher intra-group loan from subsidiary to parent
  - Lower market valuation of intra-group loan related receivables of the subsidiary
  - Lower market valuation of liquid cash on subsidiary's balance sheet

What I like about the paper

- Interesting question
- Wide array of results supporting the basic story – transfers from subsidiary to parents more likely when the parent firm is performing poorly
- On the whole quite convincing

When v.s. Which

- Want to answer: For the *same* parent-subsidiary pair are there transfers from subsidiary greater when the parent is performing badly?
  - Needs pair fixed effects, but regressions in the paper do not seem to have any fixed effects
  - Identification could be coming from the cross section
- Some parent firms are run by managers who have a high propensity to divert resources. This leads to lower ROA of the parent firm as well as tunneling from the subsidiary
  - The analysis for firms with large changes in ROA helps, but it could be driven by something else changing (e.g. manager) changing at the parent
- Suggestions: Use ROA shocks to parent instead of level or use shocks at the industry level of the parent firm

Is this expropriation?

- What we learn from the paper depends whether the documented pattern capture expropriation or quid-pro-quo arrangements
- Are subsidiaries supported when doing badly?
  - Switch parent and subsidiary in the loan regressions
  - Are such subsidiaries better at withstanding shocks in their industry?
- Is the parent firm forcing the subsidiary to transfer resources or would they do this of their own accord
  - Split sample based on fraction of independent directors on board and other independence measures

Value creation or value destruction?

- Are transfers being made when parent has better investment opportunities (but not enough cash) than the subsidiary?
- Policy implications are different:
  - Value creation – make sure that subsidiary shares are correctly priced and account for the insurance being provided to the parent
  - Value destruction – try to stop such transfers
- Suggestions:
  - Split sample based on

    Parent firm's industry Q *greater or less* than Subsidiary industry Q
  - Does performance of parent improve after receiving loan from subsidiary?

Other comments

- Faulkendar and Wang methodology widely used, but has its critics. A couple of placebo tests can help assuage concerns
  - Show that this methodology does not generate results similar to cash and intra-group loans when using other elements on the balance sheet

    e.g. (Total receivables – other receivables)
  - Show that these results do not hold for a matched firm for the publicly listed subsidiary

Other comments

- Where does the increase in cash used to extend loans to parent typically come from? Firms own cash flows or money raised externally?
- Results of the paper should hold for negative parent ROA shocks but not for positive ones
- May want to cite Gopalan, Nanada, Seru (2007)
  - Study intra-group from low controlling shareholder ownership firms to high ownership firms loans in Indian context and find they are given when the recipient firm has a negative performance shock

Conclusion

- The paper studies an interesting question: When do controlling shareholders transfer resources from a listed subsidiary? i.e. understand the incentives of the controlling shareholder
- Empirical results quite convincingly support the main story
- I enjoyed reading the paper recommend it!