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
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.
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!