An Empirical Analysis of Governance Effect of Listed Companies with Management Buyout on Corporate Performance

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Abstract The efficiency of corporate governance is reflected by the performance of a company, which means corporate governance has the positive and negative effects on the performance of this company. Based on the discussion of the theoretical basis of governance efficiency, this paper takes the listed company with management buyout (MBO) in China as samples and makes an empirical analysis of their governance effecting in 2008. Besides, it probes that the relationship between the proportion of shares held by managers and corporate performance, and the range effects of the proportion of shares.
Key words Management incentive; Governance effect; Free cash flow

1 Introduction

(Jensen and Meckling 1976) have divided the shareholders into two categories: one is internal shareholders who take the role of both managers of a company and its owners; the other is only outside shareholders. The less the shares held by the owners or managers is, the less their claims to the residual income of this business is. This will encourage them to take up additional corporate resources in the form of bonuses, more importantly, Schumpeterian innovation activities will be reduced, which causes the significant reduction of corporate value.

(Demsetz 1983) has presented that the ownership structure and corporate performance is no inherent relationship. He pointed out that the simple distribution of ownership would not result in maximizing corporate value, and ownership structure is the result of competitive selection. By comparing the various costs of different ownership structures will reach equilibrium. (Morck, Shleifer and Vishny 1988) found that ownership concentration and performance is proportional to each other.

(Stulz 1988) has assumed that from the viewpoint of acquisitions and mergers, the relationship between the corporate value and the voting rights controlled by managers was U-shaped. When the controlling right holed by managers or the ratio of stock α is small, with the increase of α, the value of this company will be increased; when α is large, as α increases, corporate value tends to decline. This assumption has been confirmed by (McComell and Servaes 1990).

(Shlerfter and Vishny 1997) have pointed out that the law can not give the effective protection to minority shareholders, but the larger shareholders can put the effective control over a company, so the larger shareholders are common in the capital markets worldwide. However, larger or controlling shareholders are not common in the United States and Britain, so hostile takeovers emerged as an alternative mechanism in these two countries. Besides, large creditors also have a lot of powers in some companies, such as Japan and Germany. However, when the interests of larger investors, other investors, managers or employees are conflicted with each other, the predatory behaviors of larger shareholders will come about. Large investors will meet their own preferences at the expense of the interests of other investors.

(Huang and Li 2004) makes the empirical research on the relevance of MBO governance performance of listed companies and the results show that if management's stake in the range of 0% to 4.41%, performance and corporate governance is at the correlation level; in the range from 4.41% to 32.88%, this relevance will be intensified. If management ownership percentage is greater than 32.88%, it will be negatively correlated with firm performance.

In summary, the appropriate change of ownership structure and capital structure will help to improve the efficiency of corporate governance; the ultimate efficiency will be reflected in the performance of a company, the carrier of corporate governance. Based on the above analysis, we have:

Assumption 1: There exists a positive correlation between corporate performance and managerial ownership.

When the residual claim of management goes up to a certain level, the welfare function will be more relevant to the company's operating results, then the interests of management and outside shareholders will come into convergence. That is, they will try to choose the best decision-making with discretion when making investment decisions, thereby to maximize shareholder wealth, but also to maximize their own interests. Furthermore, the increase of management ownership percentage will only increase the company's agency costs and lead management to seize the benefits of external shareholders. When the managers of listed companies are also a major shareholder, the management can use their information asymmetry and position to damage outside shareholders, particularly small shareholders. Thus the external management is easier to seize the benefits of shareholders in Chinese listed companies than in other countries. Based on the above analysis, we have:

Assumption 2: There exists the range effect between the company's performance and the proportion of ownership held by management.

2 Analyses Procedures and Results

2.1 Selection of samples and data resources

We collected listed companies in Shanghai Exchange and Shenzhen Stock Exchange that have completed MBO as samples and then acquired 19 samples from 2001 to 2006. The study period covers following periods: if the company conducted a number of share transfer, the data is subject to the first announcement. The data used in this paper is from the acquired company's annual report, the Shanghai and Shenzhen stock exchange announcements and other relevant reports.

2.2 Variables design

(1) Dependent variable: corporate performance indicators PERFORMANCE

Selection of variables for the above model equation is extremely important, it will affect the validity of model equations and different variable selection can also affect the estimated model parameters and test variables.

The traditional accounting performance variables are of the following two shortcomings: on the one hand, due to the accounting practices and accounting procedures under the principle of conservatism, the evaluation methods of tangible and intangible assets are not the same, and not a true reflection of the company's performance level; on the other hand, if the company's management compensation mechanism is built on the basis of accounting performance, then managers can manipulate earnings easily because of the advantages of information on these indicators. To prevent these two shortcomings affecting the results of empirical research, we selected Return on Operating Asset and free cash flow as a performance indicator, instead of the traditional indicators such as Tobin's Q value.

1) Return on Operating Asset (ROOA)

For China's securities market, taking into account changes in the performance; it is more inclined to examine the performance indicators more directly. In this case, the accounting indicators become even more a natural advantage. Therefore, this accounting more priority targets, we selected Return on Operating Asset as the company performance variables.

2) Free cash flow (FCF)

For the analysis of fundamentals of business investment decisions, there are mainly two ways: investment and growth value investing. Intrinsic value investors try to find undervalued companies, hoping to gain profits through the company's stock price return to its intrinsic value; and growth investors are committed to finding the expected future growth rate higher than the market average, expecting to gain profit through the company's future growth to make up the current high prices.

Lakonishok, Shleifer and Vishny (1994) suggest that value style investment is better than growth style investment. Value investors often use the intrinsic value of the following methods to select undervalued companies. If a company has the market price-earnings ratio below the industry average price-earnings ratio; the company's market value / net asset ratio in the industry or the market at a low level; the company's dividend / market value is higher than the market average. Here, we use free cash flow analysis to evaluate whether a company has investment value, calculated as:

Net free cash flow = Operating cash flow - [capital expenditure + incremental working capital + interest on debt maturity * (1 - tax rate) + maturity the principal amount of debt - borrowing cash from new debt] - preference dividends - preferred stock redemption back amount

For the convenience of study, free cash flow will be reduced in this paper:

Net free cash flow = Operating cash flow - capital expenditure

Capital expenditure consists of two parts: the first part of the company's ability to maintain existing production and management to purchase plant, equipment and other fixed assets and other long-term assets, intangible assets that are paid in cash. The second part is to maintain the company's market advantage and need to increase the amount of operating cash.

According to foreign scholars, in the long run, about 95% of U.S. enterprises' capital expenditures equal to depreciation and amortization. The different enterprises in market competition have different needs to increase operating cash. In view of the characteristics of listed companies, in this paper, 20% of the amount of depreciation and amortization is assumed for the need to increase the amount of operating cash. Namely:

Capital expenditure = (1 +20%) × the amount of depreciation and amortization

(2) Explanatory variables: the proportion of management ownership (PROPORTION)

(3) Control Variables

1) Company size (SIZE)

This variable is the company's natural logarithm of total assets (total assets of 10 billion for the unit).

2) Growth ability (GROWTH)

Net profit growth rate = (year net profit - net profit last year) / net profit last year

3) Asset-liability ratio (DAR)

On the assumption that a regression model was established:

$$Performance = B_o + B_1 PROPORTION + B_2 SIZE + B_3 GROWTH + B_4 DAR + \varepsilon$$

Where PERFORMANCE stands for ROOA and FCF respectively, and ε is errors.

2.3 Regression results

(1)For Assumption 1, the regression result is as follows:

Table 1 Regression Analysis between Holding Proportion of Management and Performance

	ROOA	FCF
Intercept	0.486* (14.90)	0.164* (9.78)
PROPORTION	−0.290* (−5.64)	0.002* (3.89)
DAR	−0.012 (−1.67)	0.018* (3.83)
SIZE	0.006 (1.13)	0.013* (5.36)
GROWTH	−0.085* (−4.40)	0.011 (1.17)
Adjusted R2	0.127	0.243
DW test	1.98	1.98
F statistic	7.95	16.39

In Table 1, column 1 shows that there exists a significant negative correlation between ROOA and managerial ownership, and the regression coefficient is -0.29; column 2 shows that between the ratio of free cash flow and management, there exists a significant positive correlation, indicating that free cash flow is more definite to explain the improvement of the efficiency of corporate governance than ROOA after MBO. ROOA can not pass the significance test of the possible due to the MBO listed companies may adjust accruals and other accounting items in order to manipulate earnings and other indicators. Meanwhile, due to the regulatory pressure of CPA audit and compliance of mandatory disclosure, it is hard to adjust some financial indicators such as sales of some commodities such as cash received. Therefore, we believe that, because the history of MBO in China is very short, free cash flow has a more persuasive ability to describe the improvement of the efficiency of corporate governance in MBO companies.

(2) Regression analysis of range effect of managerial ownership

The 19 sample companies are is divided into 0 to 30% and 30% respectively based on management's stake, and the regression analysis of the two groups are as follows:

Table 2 Regression Analysis between Holding Range of Management and Performance

	0～30％	Above 30％
Intercept	0.674* (11.70)	0.384* (8.74)
PROPORTION	0.280* (5.04)	0.006* (3.39)
DAR	0.032 (4.07)	0.018* (3.23)
SIZE	0.066 (6.13)	0.013* (5.36)
GROWTH	0.285* (4.40)	0.011 (1.17)
Adjusted R2	0.537	0.383
DW test	2.98	2.98
F statistic	17.85	16.48

Taking free cash flow as the performance indicators, we use 30% as the decomposition point of regression analysis. When the management stake in the range from 0 to 30%, free cash flow has a positive correlation with the share proportion of managers, which indicates that there exists consistency between the interests of management and external shareholders. If the management in this range gets more equity ratio, the company's performance will be increased; in the range above 30% stake, the ratio of free cash flow is negatively correlated with management ownership, then the increase in the proportion of management ownership will only increase the company's agency costs, lead the interests of outside shareholders tend to deviate from interests of management. When managers is not only the management of listed companies, but also major shareholder, the management can use their information asymmetry to damage outside shareholders, particularly small shareholders, then the interests of shareholders.

3 Conclusions

In the unique ownership structure of listed companies in China, MBO of listed companies is the transaction of basically non-tradable shares through the transfer of the completed agreement. Therefore, the internal and relevant shareholders (insider traders) are entirely possible to pay a limited equity transfer price. At the same time, they can gain huge speculative income with insider information from the secondary market for shares, then leads to the unique defects of the Chinese securities market system and governance crisis. We believe that, MBO of listed company should be reflected from the speculative motive and the unique structure of these companies should be incorporated into the elements of governance effect.

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