Study on Ownership Structure and Preference for Seasoned Equity Offerings of Listed Companies in China

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Abstract: Listed companies in China have a strong preference for SEO (seasoned equity offerings), which is contrary to Peking Order Theory which is appropriate for the mature capital market in Western countries. After reviewing the literature, we found academic circles think it right generally that the preference for SEO of listed companies is due to the low cost of SEO. This paper argues that China's listed companies' low SEO cost largely results from its "the largest stock-holder" of ownership structure. With the detailed analysis of the financing behavior under the control of the controlling shareholder, the paper comes to a conclusion that ownership structure of listed companies is the underlying reason for SEO preference. Finally, I give some advices for the governance on over SEO issues.
Key words: Ownership structure; Seasoned equity offerings; Financing behavior; The largest stock-holder

1 Introduction

Financing behavior is the most sophisticated one in corporate finance research areas, and many scholars have explained the capital structure and financing behavior from different aspects. In 1984, Myers[1] put forward Peking order theory based on asymmetric information theory, the theory suggests that when the corporation needs financing, internal financing is the first choice, then bond funds, and stock financing is the last one. This is confirmed by mature capital market in western developed countries in recent years.

However, the financing order of China's listed companies is contrary to the Peking order theory and the practice of Western countries, showing a preference for external financing and equity financing features. As shown in Table 1.

So, what causes so much different? Chinese scholars have done a lot of research, most of which hold the view that the cost of equity financing is lower than debt financing, which is the direct cause of preference. Huang Shaoan and Zhang Gang (2001)[2] pointed out that there is high P/E and few dividend of companies in China's primary market which led to the far less cost of equity financing than debt financing costs, which directly results in a strong preference for equity financing. Zheng Changde, Chen Xu, and Chen Lan (2003)[3] also believes that the cost of equity financing are much lower than the debt financing costs ,which is the primary factor in selection the financing way for listed companies. Liu Shaobo and Dai Wenhui (2004)[4] recalculated the cost of equity financing and debt financing of the listed companies in China, concluding that equity financing costs are significantly lower than debt financing costs obtained, resulting in the lack of financing cost-control mechanism of China's listed companies.

Table 1 International Comparison of external financing with China's Listed Companies (1998-2003)

Country	Proportion of external financing	Proportion of debt financing to external financing	Proportion of equity financing to external financing
China	0.75	0.24	0.76
USA	0.23	1.34	-0.34
Japan	0.56	0.85	0.15
German	0.33	0.87	0.13
France	0.35	0.39	0.61
Italy	0.33	0.65	0.35
UK	0.49	0.72	0.28
Canada	0.42	0.72	0.28

Source: Guan Zheng(2006),Research of Equity Refinancing of Listed Company

Some scholars attributed to the equity dual structure. Sun Yongxiang(2001)[5] think that in our current shareholding structure, the proxy contest for corporate governance failed, so the managers can do whatever they want. In order to keep their positions, they choose to maintain a conservative financial level and equity financing is more chosen. Li Zhiwen and Song Yandang (2003)[6] point out that high ownership concentration results in the coherence of the interests of controlling shareholders and management, so listed companies often transfer cash benefits to the shareholder through a variety of related party transactions. Zhang Weidong and Wang Qiao (2003)[7] point out that the equity structure of listed companies is the underlying causes of equity refinancing preference. Wujiang and Ruan Tong (2004)[8] concluded that there is a certain relationship between ownership concentration and ownership liquidity structure and equity refinancing preference, using data from 1995 to 2002, and point out that the benefits transfer mechanism formed by the split share structure is the main reason for listed companies choosing equity financing.

In this paper, the equity structure and equity refinancing behavior of listed companies in China were studied. This study has some theoretical significance to further improve the financing preference theory, and in practice, will help the efficient allocation of capital of listed companies and to improve internal corporate governance structure of listed companies.

2 Analysis of SEO Preference

2.1 Structural characteristics

There is "the largest stock-holder" phenomenon of ownership structure of listed companies in China. Moreover, most shares are the non-tradable state-owned shares and state-owned legal person shares. Because of the absence of shareholders of the state-owned shares and state-owned legal person shares, the ownership structure and corporate governance of China's listed companies are more complex.

2.2 Analysis of low cost of equity refinancing

Lower cost of equity refinancing of China's listed companies is largely determined by its "the largest stock-holder" of ownership structure. Major shareholders of listed companies control the cost of equity financing at a relatively low level by controlling the rate of dividends and allotment or issuance price.

Table 2 Current situation of Cash dividend of China's listed companies (1993-2007)

Year	Number of Com-panies	Companies which Cash dividends		Companies which profit that year		Proportion of Cash dividends Companies to profiting Companies(%)	The average cash dividends per share(￥)
		Number	Proportion (%)	Number	Proportion (%)		
1993	183	148	80.87	13	7.1	1138.46	0.149
1994	291	218	74.91	280	96.89	77.86	0.188
1995	323	203	62.85	290	91.48	70	0.165
1996	530	182	34.34	479	91.59	38	0.165
1997	745	221	29.66	675	92.21	32.74	0.172
1998	851	252	29.61	736	88.04	34.24	0.179
1999	918	294	32.03	837	89.71	35.13	0.162
2000	1054	682	64.71	958	89.87	71.19	0.134
2001	1130	676	59.82	977	85.63	69.19	0.147
2002	1193	618	51.8	1021	84.24	60.53	0.132
2003	1257	600	47.73	1097	85.77	54.69	0.142
2004	1387	729	52.56	1157	83.9	63.01	0.151
2005	1379	616	44.67	1080	77.47	57.04	0.148
2006	1460	709	48.56	1203	82.4	58.94	0.157
2007	1555	779	50.1	1486	95.56	52.42	0.141

Data source: based on data on http://www.cninfo.com.cn/

2.2.1 Control the dividend rate

As the ownership structure of "the largest stock-holder" and the lack of an effective restraint mechanism, large shareholders have absolute control over the listed companies and can control the dividend policy. It is quite common for listed companies not to pay cash dividends or pay less dividends. Seen from Table 2, 1993-2007 average cash dividends of listed companies in China is ￥0.134-0.188. Major shareholders control dividend rate at a low level, reducing the cost of equity financing while debt financing has to pay a fixed interest cost.

2.2.2 Control the SEO price

In China the stock issue is a scarce resource, so listed company can choose a high premium and the company's issued shares generally have higher P/E ratio, that is, allotment or issuance of new shares often use higher prices. The high-price placement programs or issuance of new shares is manipulated by the major shareholders, which makes the allotment or issuance of high prices can be easily implemented. So it reduces the cost of equity financing of listed companies.

2.3 Analysis of SEO preference

2.3.1 Under the control of the major shareholders, equity refinancing can often be easily achieved.

State-owned shares and legal person shares possess the absolute control right in China's listed companies, and tradable shareholders are mostly individual shareholders, with fewer institutional investors. This ownership structure of "the largest stock-holder" leads to the situation that controlling shareholders of listed companies can follow their own willing and financing price to refinance.

2.3.2 Under the control of major shareholders, equity refinancing makes the major shareholders obtain additional equity growth.

As the largest shareholders in China's listed companies are mostly non-tradable state-owned shares and legal person shares, they can't profit through secondary market transactions. Equity financing of lower cost is a better choice because P/E ratio in Chinese stock market is commonly higher, large shareholders can improve net assets per share through the high price allotment or issuance. Therefore, large shareholders are more interested in equity refinancing.

2.3.3 Under the control of the major shareholders, managers and large shareholders have a convergence of the financing preference.

China's listed companies have a very complex property relationship. State-owned shares and legal person shares possess a controlling position, but they are not in circulation , so there is the phenomenon of shareholder absence, which results manager becoming the actual controller of the listed company. Not only the largest shareholders prefer equity financing, but also management have a very strong preference to equity financing. Because the equity financing will not dilute their equity control rights, but also increase net assets and reduce the risk of bankruptcy.

3 Conclusion and Suggestion

3.1 Conclusion

There is a strong preference for equity refinancing in China's listed companies, which is contrary to the Peking order theory and the practice of Western countries. Through a detailed analysis, this paper makes a conclusion as follows:

(1)China's listed companies lower the cost of refinancing is determined by its ownership structure in a large extent.

As the ownership structure of "the largest stock-holder" and the lack of an effective restraint mechanism, large shareholders have absolute control over the listed companies and can control the stock dividend rate and allotment or issuance price, which will control the cost of equity financing at a lower level.

(2)The equity structure of listed companies is the underlying causes of equity refinancing preference.

As the ownership structure of "the largest stock-holder", shareholder can control the listed company. Under its control, the listed company's equity refinancing can often be easily achieved and major shareholders can obtain additional equity growth. Meanwhile, the listed companies under the control of major shareholders, management and major shareholders have a convergence of financing preferences.

3.2 Suggestion

Based on the above analysis, this paper proposes the following suggestion:

(1) Improving the corporate governance, regulating the behavior of large shareholders.

Controlling shareholders of listed companies in China have a larger proportion of shares, so they can easily control corporate financing, dividend distribution and other major decisions by controlling the board of directors. Therefore, we must improve the corporate governance. This paper argues, we should give full play to the independent directors and institutional investors in corporate governance. In order to improve the governance of listed companies, we should give independent directors a clear right and cultivate fund-based institutional investors, to prevent major shareholders from the occupation of listed corporate assets, abuse of fund-raising phenomenon, then to promote the major shareholders to improve business performance.

(2) Strict law enforcement and strong supervision

To regulate the refinancing behavior of listed companies, the related department should strengthen supervision of securities markets and strengthen accounting oversight, especially increase the supervision to major shareholders and senior management, punish heavily the intermediaries, for example, lawyers, appraisers, certified public accountants who collaboratively "make fraud" with the company in order to achieve the purpose of financing. Securities civil compensation system should also be established as soon as possible, increasing the offender's responsibility and making violations unprofitable.

(3) Improving the company's dividend distribution policy.

One of the reasons why China's listed companies prefer equity refinancing is the low cost of equity financing. Moreover, listed companies paying no dividends, or paying less dividends is a major reason for the low cost of equity financing. We believe that CSRC should largely promote more cash dividends, and make a rule that the company should explain the causes why not pay dividends in the annual report. The present rule about dividends paying from CSRC doesn't specify the proportion of cash dividends, so some companies only pay nominally a small percentage of cash dividends after the allotment or issuing new shares. Therefore, it is necessary for the CSRC to further set company's dividend distribution ratio of allotment or issuing.

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