DISCUSSION OF FIRM PERFORMANCE, POLITICAL INFLUENCE AND EXTERNAL SHOCKS

BY THOMAS NOE (OXFORD)

Vladimir Sokolov[1] Laura Solanko[2]

[1]ICEF
Higher School of Economics

[2]BOFIT
Bank of Finland

Fourth International Moscow Finance Conference
November 6, 2015

NOVEL, INTERESTING ASPECTS

- Subjective measure of connections, ask the managers!
- Influence over regional economic policy makers
- Quasi-shock: Replacement of regional governors following Beslan terrorist attack

NOVEL, INTERESTING ASPECTS

- Subjective measure of connections, ask the managers!
- Influence over regional economic policy makers
- Quasi-shock: Replacement of regional governors following Beslan terrorist attack

NOVEL, INTERESTING ASPECTS

- Subjective measure of connections, ask the managers!
- Influence over regional economic policy makers
- Quasi-shock: Replacement of regional governors following Beslan terrorist attack

Relation to literature

- Much of the literature focuses on
  - bailout finance or access for weak, capital-constrained firms (e.g., Claessens, Feijen and Laeven, 2008; Adelino and Dinc, 2014; Houston et al., 2014)
  - Or on state-owned enterprises (e.g., Chen et al., 2011)
  - typically, at a national level.
- This paper focuses on regional political influence over regional governments and finds a strong association between connectedness and profitability, measured by ROA

RELATION TO LITERATURE

- Much of the literature focuses on
  - bailout finance or access for weak, capital-constrained firms (e.g., Claessens, Feijen and Laeven, 2008; Adelino and Dinc, 2014; Houston et al., 2014)
  - Or on state-owned enterprises (e.g., Chen et al., 2011)
  - typically, at a national level.
- This paper focuses on regional political influence over regional governments and finds a strong association between connectedness and profitability, measured by ROA

RELATION TO LITERATURE

- Much of the literature focuses on
  - bailout finance or access for weak, capital-constrained firms (e.g., Claessens, Feijen and Laeven, 2008; Adelino and Dinc, 2014; Houston et al., 2014)
  - Or on state-owned enterprises (e.g., Chen et al., 2011)
  - typically, at a national level.
- This paper focuses on regional political influence over regional governments and finds a strong association between connectedness and profitability, measured by ROA

Relation to literature

- Much of the literature focuses on
  - bailout finance or access for weak, capital-constrained firms (e.g., Claessens, Feijen and Laeven, 2008; Adelino and Dinc, 2014; Houston et al., 2014)
  - Or on state-owned enterprises (e.g., Chen et al., 2011)
  - typically, at a national level.
- This paper focuses on regional political influence over regional governments and finds a strong association between connectedness and profitability, measured by ROA

Relation to literature

- Much of the literature focuses on
  - bailout finance or access for weak, capital-constrained firms (e.g., Claessens, Feijen and Laeven, 2008; Adelino and Dinc, 2014; Houston et al., 2014)
  - Or on state-owned enterprises (e.g., Chen et al., 2011)
  - typically, at a national level.
- This paper focuses on regional political influence over regional governments and finds a strong association between connectedness and profitability, measured by ROA

How might political connections affect firms

a. Through the "objective-function channel": connected firms may place positive valuations on government objectives, e.g., state-owned banks and cheap credit.
b. Through the "investment-opportunity channel": connected may have a comparative advantage for certain activities, e.g., obtaining procurement contracts, operating projects subject to intense regulatory scrutiny or requiring extensive capital market access.
c. While (a) generates agency costs, there is no reason a priori to believe that (b) does.
d. This paper focuses on the second channel, (b)

How might political connections affect firms

a. Through the "objective-function channel": connected firms may place positive valuations on government objectives, e.g., state-owned banks and cheap credit.
b. Through the "investment-opportunity channel": connected may have a comparative advantage for certain activities, e.g., obtaining procurement contracts, operating projects subject to intense regulatory scrutiny or requiring extensive capital market access.
c. While (a) generates agency costs, there is no reason a priori to believe that (b) does.
d. This paper focuses on the second channel, (b)

How might political connections affect firms

a. Through the "objective-function channel": connected firms may place positive valuations on government objectives, e.g., state-owned banks and cheap credit.
b. Through the "investment-opportunity channel": connected may have a comparative advantage for certain activities, e.g., obtaining procurement contracts, operating projects subject to intense regulatory scrutiny or requiring extensive capital market access.
c. While (a) generates agency costs, there is no reason a priori to believe that (b) does.
d. This paper focuses on the second channel, (b)

How might political connections affect firms

a. Through the "objective-function channel": connected firms may place positive valuations on government objectives, e.g., state-owned banks and cheap credit.
b. Through the "investment-opportunity channel": connected may have a comparative advantage for certain activities, e.g., obtaining procurement contracts, operating projects subject to intense regulatory scrutiny or requiring extensive capital market access.
c. While (a) generates agency costs, there is no reason a priori to believe that (b) does.
d. This paper focuses on the second channel, (b)

Questions

- Is the regional governor replacement decision exogenous?
- Cash holdings
  - Why are high cash holdings indicative of an agency problem?
  - Why do we think that politically connected firms have higher agency costs?
- Is political connectedness itself endogenous?

QUESTIONS

- Is the regional governor replacement decision exogenous?
- Cash holdings
  - Why are high cash holdings indicative of an agency problem?
  - Why do we think that politically connected firms have higher agency costs?
- Is political connectedness itself endogenous?

QUESTIONS

- Is the regional governor replacement decision exogenous?
- Cash holdings
  - Why are high cash holdings indicative of an agency problem?
  - Why do we think that politically connected firms have higher agency costs?
- Is political connectedness itself endogenous?

QUESTIONS

- Is the regional governor replacement decision exogenous?
- Cash holdings
  - Why are high cash holdings indicative of an agency problem?
  - Why do we think that politically connected firms have higher agency costs?
- Is political connectedness itself endogenous?

QUESTIONS

- Is the regional governor replacement decision exogenous?
- Cash holdings
  - Why are high cash holdings indicative of an agency problem?
  - Why do we think that politically connected firms have higher agency costs?
- Is political connectedness itself endogenous?

Replacement of regional governors

- Beslan terrorist attack and power centralization might well be an exogenous shock
- But, is the decision to replace specific regional governors independent of the unobserved characteristics of politically connected firms in the region.

REPLACEMENT OF REGIONAL GOVERNORS

- Beslan terrorist attack and power centralization might well be an exogenous shock
- But, is the decision to replace specific regional governors independent of the unobserved characteristics of politically connected firms in the region.

AGENCY AND POLITICAL CONNECTIONS

- Political connections appear to increase firm value even in low corruption environments (Houston et al., 2014).
- So why is the pursuit or attainment of political connectedness associated with agency costs in Russia?
- In fact, an argument can be made for reaching the opposite conclusion: suppose managers have a distaste for influence activity.

AGENCY AND POLITICAL CONNECTIONS

- Political connections appear to increase firm value even in low corruption environments (Houston et al., 2014).
- So why is the pursuit or attainment of political connectedness associated with agency costs in Russia?
- In fact, an argument can be made for reaching the opposite conclusion: suppose managers have a distaste for influence activity.

AGENCY AND POLITICAL CONNECTIONS

- Political connections appear to increase firm value even in low corruption environments (Houston et al., 2014).
- So why is the pursuit or attainment of political connectedness associated with agency costs in Russia?
- In fact, an argument can be made for reaching the opposite conclusion: suppose managers have a distaste for influence activity.

Endogeneity of connectedness

- Well-governed firms with a comparative advantage in in influencing governments will pursue influence
- Influence-based strategy will affect the firm's operating risk and thus affect its optimal asset and capital structure policies
- For example, a firm that relies on a few large government procurement contracts will have higher operating risk than firm that sells the same product to through a large number of private sales
  - Connected firm optimally will then hold larger cash balances if capital market is imperfect
  - If firm loses connections, but its strategy has not had time to adjust, then it will hold even larger balances after losing connections.

ENDOGENEITY OF CONNECTEDNESS

- Well-governed firms with a comparative advantage in in influencing governments will pursue influence
- Influence-based strategy will affect the firm's operating risk and thus affect its optimal asset and capital structure policies
- For example, a firm that relies on a few large government procurement contracts will have higher operating risk than firm that sells the same product to through a large number of private sales
  - Connected firm optimally will then hold larger cash balances if capital market is imperfect
  - If firm loses connections, but its strategy has not had time to adjust, then it will hold even larger balances after losing connections.

Endogeneity of connectedness

- Well-governed firms with a comparative advantage in in influencing governments will pursue influence
- Influence-based strategy will affect the firm's operating risk and thus affect its optimal asset and capital structure policies
- For example, a firm that relies on a few large government procurement contracts will have higher operating risk than firm that sells the same product to through a large number of private sales
    - Connected firm optimally will then hold larger cash balances if capital market is imperfect
    - If firm loses connections, but its strategy has not had time to adjust, then it will hold even larger balances after losing connections.

Endogeneity of connectedness

- Well-governed firms with a comparative advantage in in influencing governments will pursue influence
- Influence-based strategy will affect the firm's operating risk and thus affect its optimal asset and capital structure policies
- For example, a firm that relies on a few large government procurement contracts will have higher operating risk than firm that sells the same product to through a large number of private sales
  - Connected firm optimally will then hold larger cash balances if capital market is imperfect
  - If firm loses connections, but its strategy has not had time to adjust, then it will hold even larger balances after losing connections.

Endogeneity of connectedness

- Well-governed firms with a comparative advantage in in influencing governments will pursue influence
- Influence-based strategy will affect the firm's operating risk and thus affect its optimal asset and capital structure policies
- For example, a firm that relies on a few large government procurement contracts will have higher operating risk than firm that sells the same product to through a large number of private sales
  - Connected firm optimally will then hold larger cash balances if capital market is imperfect
  - If firm loses connections, but its strategy has not had time to adjust, then it will hold even larger balances after losing connections.

DEALING WITH ENDOGENEITY?

- Would a difference-in-difference approach help?
  - Compare Δ(ROA) (before and after Beslan terrorist attack) of *connected* firms experiencing governor replacement and not experiencing replacement.
  - Compare Δ(ROA) (before and after Beslan terrorist attack) of *unconnected* firms experiencing governor replacement and not experiencing replacement.
- Investigate whether replacement is a function of regional economic or governance characteristics.

Dealing with endogeneity?

- Would a difference-in-difference approach help?
  - Compare Δ(ROA) (before and after Beslan terrorist attack) of *connected* firms experiencing governor replacement and not experiencing replacement.
  - Compare Δ(ROA) (before and after Beslan terrorist attack) of *unconnected* firms experiencing governor replacement and not experiencing replacement.
- Investigate whether replacement is a function of regional economic or governance characteristics.

DEALING WITH ENDOGENEITY?

- Would a difference-in-difference approach help?
  - Compare Δ(ROA) (before and after Beslan terrorist attack) of *connected* firms experiencing governor replacement and not experiencing replacement.
  - Compare Δ(ROA) (before and after Beslan terrorist attack) of *unconnected* firms experiencing governor replacement and not experiencing replacement.
- Investigate whether replacement is a function of regional economic or governance characteristics.

Dealing with endogeneity?

- Would a difference-in-difference approach help?
  - Compare Δ(ROA) (before and after Beslan terrorist attack) of *connected* firms experiencing governor replacement and not experiencing replacement.
  - Compare Δ(ROA) (before and after Beslan terrorist attack) of *unconnected* firms experiencing governor replacement and not experiencing replacement.
- Investigate whether replacement is a function of regional economic or governance characteristics.

A BIT MORE EXPLANATION?

- Is there an institutional reason for agency to be linked with political influence in Russia?
- How exactly to these firms use their influence:
  - Affect overall regional policy toward their industry
  - Obtain government contracts?
  - Extract firm-specific favors?

A BIT MORE EXPLANATION?

- Is there an institutional reason for agency to be linked with political influence in Russia?
- How exactly to these firms use their influence:
  - Affect overall regional policy toward their industry
  - Obtain government contracts?
  - Extract firm-specific favors?

A BIT MORE EXPLANATION?

- Is there an institutional reason for agency to be linked with political influence in Russia?
- How exactly to these firms use their influence:
  - Affect overall regional policy toward their industry
  - Obtain government contracts?
  - Extract firm-specific favors?

A bit more explanation?

- Is there an institutional reason for agency to be linked with political influence in Russia?
- How exactly to these firms use their influence:
  - Affect overall regional policy toward their industry
  - Obtain government contracts?
  - Extract firm-specific favors?

A BIT MORE EXPLANATION?

- Is there an institutional reason for agency to be linked with political influence in Russia?
- How exactly to these firms use their influence:
  - Affect overall regional policy toward their industry
  - Obtain government contracts?
  - Extract firm-specific favors?

Summary

- Paper considers a fairly novel aspect of political connectedness (except for Amore and Bennedsen, 2013).
- Policy relevant
- Clearly worth reading
- A bit more work perhaps before shipping off to the *Journal of Finance*.

SUMMARY

- Paper considers a fairly novel aspect of political connectedness (except for Amore and Bennedsen, 2013).
- Policy relevant
- Clearly worth reading
- A bit more work perhaps before shipping off to the *Journal of Finance*.

Summary

- Paper considers a fairly novel aspect of political connectedness (except for Amore and Bennedsen, 2013).
- Policy relevant
- Clearly worth reading
- A bit more work perhaps before shipping off to the *Journal of Finance*.

Summary

- Paper considers a fairly novel aspect of political connectedness (except for Amore and Bennedsen, 2013).
- Policy relevant
- Clearly worth reading
- A bit more work perhaps before shipping off to the *Journal of Finance*.