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PolyU Study Finds The State Isn't That Great

Types of ownership can be crucial determining factors in hotel firm performance. Indeed, domestic and international institutional shareholders have different effects on the performance of hotel firms in China, according to Dr Henry Tsai of the School of Hotel and Tourism Management (SHTM) at The Hong Kong Polytechnic University and his co-researchers. In a recent study, the researchers found that firms with high levels of state ownership performed poorly in terms of future growth potential, but the effects of domestic and international shareholders were rather more complex.

China's hotel industry has grown tremendously in recent years, from 137 hotels with less than 16,000 guest rooms in 1978 to 11,180 hotels with 1.5 million rooms in 2014. The researchers note that this expansion began with the introduction of the Open Door policy, which allowed many international hotel chains to enter the market, accompanied by "surging demand" from domestic tourists. The Belt and Road initiative of investment and infrastructure development through 65 countries, implemented in 2015, has brought further noteworthy opportunities for the hotel sector, and indeed the entire hospitality and tourism industry.

With these developments, the hotel sector has become an important constituent of China's economy, and its performance deserves "careful attention", according to the researchers. In particular, how the ownership structure of Chinese hotel firms affects their performance should be monitored, because the state has "maintained a strong influence in many publicly listed hotel firms".

Unfortunately, although state-owned firms have become more profitable, they still underperform non-state-owned firms by about 10%. One reason for their poor performance, the researchers suggest, is their failure to "prudently separate management from ownership", which leads to poor monitoring and control. In developed economies, institutional investors tend to engage in active monitoring of management and to voice disagreement when dissatisfied, because it is "more beneficial and lucrative" for them to boost stock performance than to "exit and sell their stocks at a loss".

This seems to suggest that allowing institutional investors to invest in state-owned hotel firms in China might improve their monitoring and corporate governance. Institutional investors have, in fact, become what the researchers describe as a "strong force" in China's securities market since 2000, and have been influential in "shifting hotel ownership from the state to non-government enterprises". However, it is not unusual for the government to intervene in the tourism sector by helping firms to "obtain funding from the securities market and incentivise investment", which may complicate firm governance and prevent effective monitoring, leading to underperformance. Hence, it is unclear whether institutional investors have an overall positive effect in China.

The situation is further complicated by the difference between foreign and domestic institutional investors. Foreign investors in developing economies usually have positive effects on economic development and employment because they bring advantages such as greater technological, financial and human expertise and international experience. Domestic institutional investors, on the contrary, may have less positive effects on firm performance because they are more likely to be government affiliated, less profit driven and less vigilant in their monitoring role.

The researchers thus aimed to clarify the various influences of foreign and domestic institutional investors to examine "how China's share reform may have influenced the performance of hotel firms" and to offer insights into "how corporate governance in the transitional economy can be improved".

The researchers conducted a series of analyses to examine the effects of institutional holdings on firm performance. They selected six hotel firms – Century Plaza, Huatian, Lingnan, Dadonghai, Jinjiang and Jinling – and collected information on their performance over 18 years. They also collected information on the proportion of shares held by international shareholders, domestic shareholders and the state.

To assess firm performance, the researchers used various measures, including return on assets and return on equity to measure past performance and stock returns and a variant of Tobin's Q to measure future growth opportunities. Tobin's Q, the researchers comment, is a "commonly used corporate finance measure", which is high when the firm "has valuable intangible assets in addition to its physical capital" and indicates the firm's growth potential.

To rule out the influence of other factors, the analyses also included measures such as the size of the firm, the growth rate of China's gross domestic product, the firm's financial leverage and the growth rate of its sales revenue.

When looking at international and domestic institutional holdings overall, the researchers found that as institutional shareholdings increase, performance initially improves up to a point, and then declines. The most likely explanation, they remark, is that up to a certain level, institutional shareholders improve performance by expressing their dissatisfaction to the management.

However, beyond an "optimal point", it becomes too costly for institutions to sell off all their shares when a firm is performing poorly. This potentially causes a conflict of interest and the development of a "strategic alliance" between the management and the institution, thus further worsening performance.

A rather different picture emerged when foreign and domestic investors were considered separately. Rather surprisingly, most of the effect of institutional holdings on performance came from domestic investors. As domestic holdings increased, firm performance measured by return on assets and return on equity at first decreased before increasing, which suggests that investors' monitoring efforts eventually "seemed to start paying off". However, domestic holdings had the opposite effect.

The researchers surmised that there must be an "optimal point" between the level of domestic institutional holdings and optimal firm performance. Their calculations indicated that Chinese hotel firms should "seek to increase and attract" domestic institutional shareholding to a level of at least 17.3% but no greater than 25% to optimise return on assets and return on equity.

These values were calculated on the averaged values from the six hotels, and thus the researchers acknowledged that they "may not be precisely applicable to each individual firm". The hotels could benchmark their levels of domestic holdings against the calculated optimal points to decide whether they should "continue to engage or disengage" such investors to enhance their performance.

State holdings were negatively related to hotel firm performance, which the researchers state "clearly reflects the fact that some Chinese hotel firms were still under the influence" of state ownership and have "less opportunity for growth". It would be wise, they suggest, for the governing authorities to reduce the state's ownership of hotel firms, while continuing to maintain support for the industry.

Contrary to expectations, foreign institutional shareholders did not seem to "exhibit any impact on the four hotel performance measures". A possible explanation for their ineffectiveness, the researchers posit, is that there are too few of them to make a difference: only 3.5% of shares were held by foreign institutions. The researchers explain that foreign investors tend to "operate on the principle of portfolio diversification", and thus have limited power and incentive to "exert their professional knowledge" and "contribute directly to corporate governance" to enhance firm performance.

This finding is important because it suggests that the Chinese government's decision to open up the capital market has not had the intended positive effect, at least among hotel firms. However, it is still likely that foreign investors will exert a positive influence if their shareholdings increase in the future. Chinese hotel firms, the researchers urge, should "work on encouraging and attracting" foreign domestic investors so that they have greater incentives and power to exert their monitoring expertise and corporate governance.

The study provides hotel firms in China with clear insights into how best to balance their ownership structure. Yet given that share reform in China is what the researchers describe as a "work in progress", they conclude with the caution that the effects of institutional ownership may differ in other hospitality and tourism sectors and in other countries. Further research could show just how different the Chinese context is in this case.

Chen, Ming-Hsiang, Tsai, Henry and Lv, Wan Qing. (2018). The Effects of Institutional Holdings and State Ownership on Hotel Firm Performance in China, *Journal of China Tourism Research*, 14(1), 20-41.

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