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RESEARCH ARTICLE

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Does high dividend payout protect investors?
—A case study of Chihong Zinc & Germanium

Abstract This paper studies the relationship between dividend payout and investor protection through the case of Chihong Zinc & Germanium's (Chihong) reform of nontradable shares. Results show that Chihong's nontradable share reform integrated with equity offering may usurp the interest of small shareholders. Statistics manifest that market responds negatively to this type of dividend allocation. Managerial suggestions are also provided.

Keywords nontradable shares reform, expropriation, dividend payout

摘要 以股权分置改革为背景，研究驰宏锌锗的股利分配行为与投资者利益保护的关系。结果表明，驰宏锌锗的分置改革与定向增发导致股利分配有大股东套现和侵占中小股东利益之嫌。股利分配事件研究的结果表明，市场呈消极反应。因此，提出相关管理变革建议。

关键词 股权分置改革，利益侵占，股利分配

1 Introduction

On March 9, 2007, Chihong issued an annual report, publicizing its forward plan for dividend payout. The plan aimed to give 10 bonus shares together with a cash bonus of 30 yuan (pretax) for every 10 shares held by all the shareholders. Altogether, the total cash dividend reached 585 million yuan. The remaining

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dividends would be settled and transferred for the dividend payout of the next year. The forward plan was then approved by the conference of shareholders on April 2, 2007.

To date, Chihong has set three records in China's capital market: the highest share price,[1] the highest earning per share and the highest cash bonus dispatched. For these reasons, Chihong has become widely known within a short time.

However, to investors' confusion, on March 9, the same day when its dividend payout plan was announced, Chihong's share price fell into an awkward situation, started with a high opening price and ended with a low closing price (with a discrepancy of nearly 8 yuan). In the following 10 days, Chihong's share price remained weak. However, in the corresponding period, the composite index of Shanghai Stock Exchange rose by 6.6%. What is the reason behind Chihong's unprecedented generous dividend payout behavior in the history of China's securities market? That is, give 10 bonus shares for every 10 shares held plus a cash bonus of 30 yuan?

Why do listed companies pay dividends? Why do investors love dividends? And why do analysts suggest investors buy shares of those companies offering stable dividends? These seemingly simple questions are hard to obtain unanimous answers in theory. Black (1976) called this knotty theory Puzzle of Dividends.

Just like what has been pointed out by Bar-Yosef and Kolodny (1976) that in specific times, there are no definite conclusions concerning why companies pay dividends. However, researchers have failed to find any convincing evidence to solve the puzzle of dividends.[2] However, one point should be clear that if we want to have a further understanding of the Puzzle of Dividends in China, we have to loosen the restrictive conditions demanded by the hypothesis of perfect market (Crockett and Friend, 1988) and meanwhile we should take the specific factors from the market of China into consideration.

It is against the backdrop of the nontradable shares reform in the list companies in China, this paper studies the above dividend payout behavior of Chihong. What was the reason behind the company's behavior of handing out the largest bonus in the history of Chinese securities? Will such kind of dividends dispatched effectively reduce agency cost? If the cost can not be reduced, will it cause a larger expropriation of the interests of small shareholders? Or can this

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[1] On March 9, the share price of Chihong surpassed that of Guizhou Maotai.

[2] There are three theories trying to explain the Puzzle of Dividends: Agency Theory (Rozeff, 1982; Jensen, 1986; Laporta etc., 2000; Faccio, Lang and Young, 2001); Signal Theory (Riley, 1979; Aharony and Swary, 1980; Asquith and Mullins, 1983; Bhattacharya, 1979; John and Williams, 1985; Miller and Rock, 1985) and Behavioral Finance Theory (Thaler and Kahneman, 1981; Shefrin and Statman, 1984).

phenomenon be explained as the fact that Chihong only intended to send a signal to the market that the company would have a more prosperous future? Then if the reason lies in the sending of the signal, why did the share price of the company decreased by 10% within 10 days after the signal whereas the Shanghai composite index in the corresponding period increased by 6.6%?

This paper is organized as follows: the second part is a literature review concerning the functions of dividend payout. The third part mainly focuses on analyzing the special characteristics in Chihong. In the fourth part, we will analyze some of the phenomena worth noting in the process of nontradable shares reform in Chihong. Then we attempt to find evidence of expropriation of the small shareholders in this dividend payout. Finally, conclusion and suggestions are provided in the sixth part.

2 Functions of the dividend payout: Literature review

Since the establishment of Shenzhen Securities Exchange in 1990, the payment of dividends by list companies in China has experienced changes in the payment ratios from high to low and then to high again. Studying the effects of dividend payout on protecting the interests of investors constitutes an important perspective for understanding expropriation of small shareholders by controlling shareholders in listed companies. Influences of dividend payout on protecting investors can be analyzed from three aspects: (1) from the global aspect, interior shareholders may possibly use the remaining profits to invest in inefficient or low-efficient programs (La Porta etc., 2000). Thus compared with the remaining profits, exterior shareholders prefer dividends. La Porta et al. (2000) used the cross section samples of 4,000 companies in 33 countries to check the two agency models of dividend payout, namely, the result model and substitution effect model. Their results showed that dividend payout can be understood as a mechanism of protection of the interests of small investors. In fact, the essence of this conclusion is consistent with that of Jensen’s (1986), who found out that when there is a free cash flow in a company,[3] the conflict of interests between the shareholders and the managers tends to become more serious. The managers will be inclined to pay no dividends or reduce the dividends paid. Then the free cash flow will be preserved for the interior use of the company. Also, they can freely use those capitals for personal interests or carry out excessive investment.

[3] According to the definition by Jensen (1986), if the current value of certain program, when the capital assets are discounted, is positive, the program is then worthy investing. And if the cash flow surpasses the investment cash flow for all the programs with positive current values, the surpassed part will be called free cash flow.

Thus the use efficiency of the capitals will be reduced, resulting in increased agency cost. Under such circumstances, a higher dividend payout can reduce the amount of cashes controlled by the managers to a minimum level and can prevent the capitals from being invested in programs with minus profits. Then from this perspective, high dividend payout policy can reduce the agency cost. The research result of Faccio, Lang and Young (2001) indicated that dividends, as a method to restrict interior people from expropriating interest of exterior people, are applicable in both Europe and Asia. They discovered that the dividends paid by the European companies are higher than that of in Asian companies. They attributed the strong legislative support in European countries to this phenomenon. (2) In China, there have been studies on the dividend payout behavior of listed companies from the perspective of agency problem. However, the conclusions of these studies varied greatly with one another. For example, Wei(1998) found that out of the consideration of expropriation of small shareholders, large shareholders are inclined not to pay dividends, while Lan(2001) argued that cash dividends and share rations serve for the purpose of cashing out by the controlling companies. Lee etc. (2002), Chen etc. (2003) even contended that issuing cash dividends is an essential tool for the large shareholders to circling money. Obviously, the latter conclusions can better explain the reason why the stock market in China usually has a negative response to the cash dividends. However, such conclusion was not supported in the empirical studies of Wu et, al (2003). Studies that followed tended to understand cash dividends as a method for controlling shareholders to transfer resources of the listed companies to expropriate the interest of small shareholders (Chen and Xiong, 2001; Yu and Xia, 2004; Lü and Zhou, 2005). The reason lies in the fact that the prices of non-tradable shares are far lower than those of circulating shares. As a result, the returns obtained by controlling shareholders from the same amount of cash dividends are considerably higher than those obtained by small shareholders. (3) From the aspect of nontradable shares reform. Nontradable shares reform refers to the two different types of shares (nontradable shares and tradable shares in the market) extensively exist in the A-share companies China's stock market, resulted from the special historic reasons and the special evolution of the Chinese stock market. The two types of shares vary with prices and rights. Nontradable shares reform may trigger vicious money circling, excessively high P/E ratio (price to earnings ratio) in the market, and vague orientation of the stock market, which in turn will affect Chinese stock market's compatibility with international stock markets. Then in the process of nontradable shares reform, what's the relationship between the dividend payout and the protection of investors' interest? There has been little study focusing on this issue, which makes the study of the effect of dividends on protection of investors' interests even more challenging under the background of China's nontradable shares reform: First of all, current literature on the relationship between the dividend payout and the protection of investors' interest seldom take the background of nontradable shares reform into consideration. Second, the long history of dividends division in China has a far-reaching effect on the non-tradable shareholders. Accordingly, the relationship between dividend payout and the protection of investors' interest shall also have some "Chinese characteristics". Considering these problems, it is necessary for us to review the characteristics and shares reform process of Chihong.

3 Review of Chihong's nontradable shares reform

The full name of Chihong (600497) is Yunnan Chihong Zinc & Germanium Co., Ltd. On July 18, 2000, with the approval from the Economic Reform Committee of Yunnan Province (No. [2000] 33), Chihong registered in the Industrial and Commercial Administration Bureau of Yunnan Province and was formally established with a total capital stock of 90,000,000 shares. The ownership structure of the company was characterized by large controlling shareholders with comparatively large shares. The share of the company held by Yunnan Metallurgy Group (the largest shareholder and abbreviated as Yunye Group henceforth) was 50 times than that of held by Qujing Fusheng Lead & Zinc Co., Ltd, as shown in Table 1.

Table 1 Shares structure of Chihong (December 31, 2006)

Shareholders	Percentage of shares held (%)	Number of shares (10,000 shares)	Nature of the shares
Yunye Group	51.32	10,007.91	Limited circulating shares
Qujing Fushen Lead & Zinc Co., Ltd	1.33	259.52	Limited circulating shares
Huize County State-Owned Assets Holding Operation Co., Ltd.	1.07	207.62	Limited circulating shares
China Construction Bank-Hua'an Hongli Stock-Type Securities Investment Fund	0.92	179.45	A-type tradable shares

(*To be continued*)

(*Continued*)

Shareholders	Percentage of shares held (%)	Number of shares (10,000 shares)	Nature of the shares
Yunnan Province Yilihe Industry Co., Ltd	0.53	103.81	Limited circulating shares
He Lijun	0.53	103.11	A-type tradable shares
Bank of Communications-Anshun Securities Investment Fund	0.51	99.99	A-type tradable shares
Chen Zhiming	0.45	87.41	A-type tradable shares
Jingyang Securities Investment Fund	0.41	80	A-type tradable shares
Agriculture Bank of China-Changcheng Anxinhuibao Mixed-Type Securities Investment Fund	0.34	66.68	A-type tradable shares

The controlling shareholder of the company is Yunye Group, who held more than 50% shares of Chihong for the past three years (except in the middle 2006, when the percentage of share held by the group fell down to only 40%) Yunye Group was a diversified enterprise of mining, mineral separation, smelting, chemistry industry, processing, exploration, scientific research, design, construction, domestic and foreign trade, and higher education of smelting. It is one of the largest enterprises in Yunnan Province in the industry of nonferrous metals. At the end of 2006, the percentage of Chihong's shares held by Yunye Group reached 51.32%. Moreover, out of the 9 directors in Chihong, 5 boarders were from Yunye Group (see Table 2). At present, the direct owner of Yunye Group is Yunnan Province Supervision and Administration Committee of State-Owned Assets. Until April 24, 2006, Wholly-owned subsidiaries and holding subsidiaries subordinated to Yunye Group are shown in the following Fig. 1.

Table 2 Composition of the board of directors in Chihong

Name	Name of the unit the director currently works in	Position of the director in the unit he/she currently works in	Starting Date of the Tenure
Dong Ying	Yunye Group	General manager, vice-director of the Party committee	November, 2002
Wang Hongjiang	Yunye Group	Deputy-manager, member of the standing committee of the Party	August, 2004
Yu Deqing	Yunye Group	Chief engineer, member of the standing committee of the Party	August, 2002
Zhou Qiang	Yunye Group	Deputy-manager, member of the standing committee of the Party	August, 2006
Gu Kunsheng	Qujing Fusheng Lead & Zinc Co., Ltd	Vice president	1993
Zhang Ziyi	Yunye Group	Chief accountant	December, 2005
Xie Chaodong	Yunnan Province Huize County State-Owned Assets Holding Operation Co., Ltd	President and general manager	September, 2002
Chen Songping	Yunnan Yilihe Industry Co., Ltd	Director of the marketing department	January, 2001
Yang Herong	Kunming University of Technology	Director of the supervision section	August, 2003

As shown in Fig. 1, Chihong is one of the holding subsidiaries and Zhaotong Lead & Zinc is one of the wholly-owned subsidiaries of Yunye Group. Chihong bound its nontradable shares reform with a tailored equity offering of Yunye Group. Furthermore, the plan of tailored equity offering enabled Chihong to purchase 100% equity of Zhaotong Lead & Zinc by issuing 35,000,000 A shares. Superficially, Yunye Group just transferred its assets which were originally put in two bags into one bag. However, the behavior of assets transferring dramatically increased the profits of Yunye Group at the end of 2006 (see Table 3). Profits obtained after the transfer increased about 14 billion yuan.

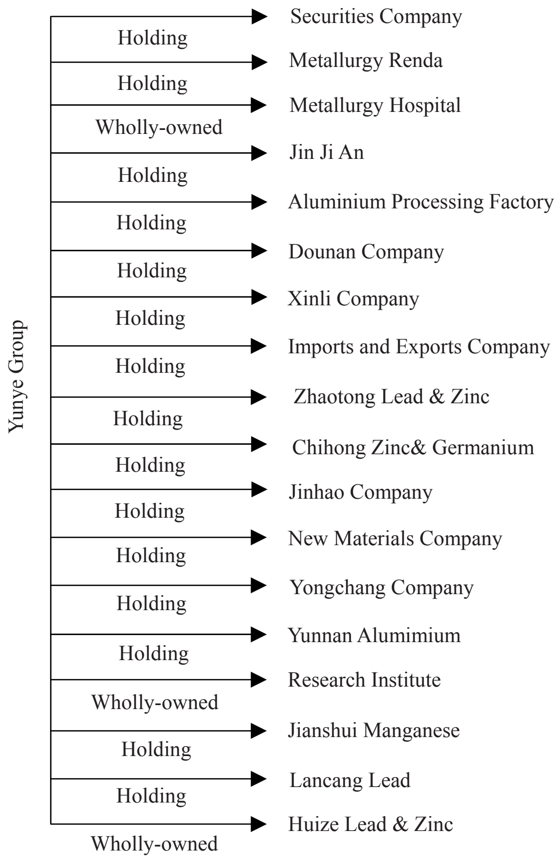

Fig. 1 Wholly-owned subsidiaries and holding subsidiaries subordinated to Yunye Group

Table 3 Comparison of the influence of Chihong's tailored equity offering on controlling shareholders with that of without tailored equity offering

	Without tailored equity offering	With tailored equity offering
Percentage of shares Held by Yunye Group	40.67%	51.32%
Total number of Shares Held by Yunye Group	65,079,100 shares	100,079,100 shares
Predicted profit of Zhaotong Lead & Zinc at the End of 2006[4]	111,720,400.00 yuan	
Investment returns of Yunye Group in Chihong and Zhaotong Lead & Zinc in 2006	3,020,105,400. 00 yuan	4,472,535,000.00 yuan

[4] According to the yearly performance of Zhaotong Lead & Zinc in 2005, its operation capability and marketing plan in 2006 and 2007, and other relevant materials, based on the regular accounting policy applied in Zhaotong Lead & Zinc and following the principle of being cautious, Yatai Zhonghui Certified Public Accountants Co., Ltd forecasted that at the end of 2006, the net profit of Zhaotong Lead & Zinc would reach RMB 111.720 million yuan.

4 Shares reform process in Chihong

Chihong is the first Chinese listed company to integrate nontradable shares reform with tailored equity offering. As a result, the nontradable shares reform and tailored equity offering complement each other and promote the company's performance dramatically. For this reason, the preparatory stage of Chihong's shares reform took a record long period of two months (the trading suspension period lasted from February 25 to April 24, 2006). Unfortunately, before the reform plan was officially announced, the company faced strong opposition from its small shareholders. On April 12 and April 22, about 200 small shareholders send two public letters respectively to the *Public Securities News* and *Financial Investment News*, denouncing that Chihong's prolonged trading suspension seriously damaged the interests of its tradable shareholders (during the trading suspension period, the prices of shares in the same industry skyrocketed). They charged the company of maliciously prolonging the trading suspension, reducing the share price and thus decreasing the price of tailed equity offering, and possible tunneling of large shareholders. Shareholders appealed to China Securities Regulatory Commission (CSRC) to re-list the share as soon as possible and punish the behavior of integrating tailored equity offering with nontradable shares reform. But what we are curious about is that whether there is expropriation of small shareholders by large shareholders. If yes, why did CSRC finally approve the plan? If there was not any expropriation, why did CSRC later regulate that nontradable shares reform should not have a trading suspension period longer than four trading days?

In order to explain this phenomenon, we have to carefully study the process of low-price tailored equity offering of Chihong. On April 24, Chihong announced that its holding shareholder, Yunye Group would individually have tailored equity offering by capital subscribing and meanwhile, the tailored equity offering process would be integrated with the nontradable shares reform. The base day for the tailored equity offering price was April 24 and the fixed price followed the average closing quotation within 20 trading days before February 24 (two months apart from the base day). Then the tailored equity offering price was fixed at 19.17 yuan/share. Since Chihong's share were greatly depressed in price during its record long trading suspension period, the share prices soared continuously for five straight trading days (from April 25 to May 8) after the re-listing. Before the voting for shares reform, Chihong's share price had reached 33 yuan/share. Thus the two months' prolonged trading suspension, on one hand, would cause loss of the small shareholders' potential interests. On the other hand, large shareholders got the chance to become rich suddenly through tailored equity offering.[5] Realizing this, many of Chihong's shareholders organized a series of activities, trying to reject the approval of nontradable shares reform bounded with tailored equity offering. However, with powerful support from fund company shareholders, the plan of tailored equity offering in was finally approved by the Chihong's shareholder meeting.

At the beginning of September, 2006, Chihong delivered an application for tailored equity offering to the Review Sub-Committee for Mergers, Acquisitions and Restructurings of Listed Companies of CSRC but was refused. But the company's second application was approved. Reviewing the process of the two applications, we found four doubtful phenomena:

(1) Phenomenon 1: Sales after baling versus breaking up the baling after buying

On February 24, 2006, Chihong disclosed for the first time its instructions for nontradable shares reform, announcing the stock changes price in the nontradable shares reform was 2.3 for every 10 shares. Meanwhile, the company pointed out that it intended to add new shares to its holding shareholder Yunye Group to purchase the lead & zinc resources and the assets of lead & zinc mining and lead smelting from the parent company. Afterwards, we found that Yunye Group had made a series of preparation work for the reform. First of all, on March 28, 2006, Provincial State Resources Committee issued the [2006] 89 Document of Yunnan State Resources Programming, named *Approval of Yunnan Provincial State Resources Committee for the Establishment of Yunnan Lixin Nonferrous Metals Co., Ltd*. The document agreed on the establishment of Lixin Company, which originated from Qujing Branch Company of Yunnan Xinli Nonferrous Metals Corporation with its operation nature changed. Second, three days later, (March 31, 2006), another government document named *Notice about Yunye Group Transferring Bonds of Yunnan Lixin Nonferrous Metals Co., Ltd* was issued and then a 100% bond of Lixin Company was transferred to Zhaotong Lead & Zinc. Third, on April 21, 2006, Yunye Group and Chihong signed the *Agreement on Additional Equity Offering and Assets Pursuing*. Chihong planned to give Yunye Group additional 35,000,000 A shares to purchase 100% bonds of Zhaotong Lead & Zinc owned by Yunye Group. However, after the pursuing, we found that Chihong only remained the legal person status of Zhaotong Lead & Zinc. The legal person status of Xinli Company was cancelled, whose lead smelting and zinc smelting businesses were merged by Chihong and managed by the former Qujing Branch Company of Xinli. We were confused by these phenomena. It is

[5] Afterwards, Shanghai Stock Exchange issued special document, demanding that at the brewing stage of the shares reform plan, the length of trading suspension of a company's share shall not be longer than four trading days.

obvious that after the pursuing, the usage of those assets purchased was different. Then Chihong could have respectively purchased the mining assets of the original Zhaotong Lead & Zinc and Qujing Branch Company of Xinli Company. Then why did Yunye Group separate Qujing Brach Company from Xinli Company and establish a Lixin Company? And why was Lixin Company turned over to Yunnan Zhaotong Lead & Zinc afterwards? Finally, why was Xinli Company purchased by Chihong? We have tried to look for relevant assets evaluation of Qujing Branch Company (Lixin Company) of Xinli Company and also its assets evaluation after it was incorporated with Zhaotong Lead & Zinc. Regretfully, we did not find any further evidence.

(2) Phenomenon 2

On February 24, 2006, Chihong disclosed its preliminary plan for nontradable shares reform. Shareholders of nontradble shares was planned to pay 16,100,000 stocks to shareholders of tradable shares, which meant that since the implementation of the reform plan, as for registered shareholders of tradable shares, for each 10 tradable shares they held, they would obtain 2.3 shares given by the shareholders of nontradable shares. As soon as the preliminary plan was issued, it faced strong opposition from small shareholders, who asked Chihong to offer an actural consideration of no less than 0.25 of the service ratio. Thus in the last time when Chihong publicized its plan for nontradable shares reform, the share consideration of the reform was adjusted higher to 2.7 shares for each 10 stocks held.

(3) Phenomenon 3

On May 18, 2006, small shareholders raised funds to employ a lawyer and sued Chihong at Shanghai Pudong Court, accusing the behavior of integrating tailored additional equity offering with nontradable shares reform of being illegal. On May 21 and May 22, fund shareholders (meanwhile they are also shareholders of Chihong tradable shares) from Nanjing, Jiangsu and Shanghai entrusted the lawyer to write letters to the three largest fund companies of Chihong among the ten largest shareholders of tradable shares, asking those fund companies to vote against the proposal of Chihong for tailored additional equity offering in the board meeting and try to prevent the proposal of tailored additional equity offering with low prices from being passed. On May 23, Liang Li, a small shareholder in Nanjing appealed to Shanghai Securities Exchange for Chihong's inaction during the process of low-price additional equity offering and the period of trading suspension, resulted in loss of investment chances for small shareholders and heavy damages to their interests.

(4) Phenomenon 4

The largest shareholder, Yunye Group added a promise in its second application to the *Review Sub-Committee for Mergers, Acquisitions and Restructurings of Listed Companies* of CSRC, saying that if the value of the company's newly added shares is not enough to pay the assets purchased, the payment of the fund gap will be exempted.[6] Because of this, Chihong's actual price of additional equity offering increased by 3.74 yuan to 22.91 yuan. Why did large shareholders be exempt from paying 131million yuan? Is it true that if the nontradable share reform was approved by CSRC in the first time, nobody would have taken the 131million yuan into consideration?

Apart from what has been discussed so far, we also found that three days before the nontradable shares reform and trade suspension, Chihong issued an announcement, predicting that in the first quarter of 2006, the company's net profit would increase by 150% on a year-on-year basis. But the actual increase was as high as 230%. Likewise, Chihong predicted that the company's net profit in the first half of 2006 would be 300% on a year-on-year basis. But the actual increase was a much higher 606%. Though it is normal to have some differences between the predicted increase and the actual increase, such huge deviations are suspicious of depressing share prices on purpose with an aim of obtaining low-priced additional equity offering.

5 Evidence for expropriation of profits

Generally speaking, there are mainly two methods for controlling shareholders to transfer assets: cash dividends and related trade. The supervision on related trade from CSRC is relatively strict, which discourages controlling shareholders from using related trade to transform cashes. However, dividend is only one of the ways of profit dividing. If it does not violate relevant regulations, even though it might cause adverse effects on the other shareholders, it will be exempted from

[6] Chihong intended to use additional 35 million A-shares to purchase the 100% shares of Zhaotong Lead & Zinc owned by the Metallurgy Group. The net assets of Zhaotong Lead & Zinc were 825.348 million Yuan by evaluation. According to the *Notice about Submitting Dividends* of the Metallurgy Group on January 26, 2006, the undivided profit of Zhaotong Lead & Zinc needed to submit to the Metallurgy Group on the base date of the evaluation was 23.510 million Yuan. Thus the actually purchase price was RMB 801.838 million Yuan. Since the face value of each newly added share was 1 Yuan and the price was 19.17 Yuan (the arithmetic average value of the closing quotations of the company's A shares 20 trading days before the holding of the board meeting). The newly added shares were not sufficient to pay for the purchase (with a gap of 130.888 million yuan). The Metallurgy Group agreed to allow Chihong to pay off the gap by cash one year after the delivery day.

government intervention or punishment by the law. Nevertheless, suspicion of dividends division being illegal can not be avoided.

The paper mainly tends to seek for evidence for controlling shareholders' expropriation of small shareholders from the largest dividends distribution by Chihong in the history of Chinese stock market. After a review of relevant research at home and abroad, it can be said that several situations are indicators of controlling shareholders' possible expropriation behaviors through dividends distribution: first, a listed company has a promising program, which demands a large amount cash, but controlling shareholders still insist on large-scale cash dividends. Moreover, cash allotted for each share surpasses the net value of the cash flow from the operational activity for each share in the current year (Duan, 2002); second, the price of the share held by controlling shareholders is lower than that of the share held by the other small shareholders (Chen and Xiong, 2001; Xia and Yu, 2004); third, stock market respond negatively to the dividends division (Lü and Zhou, 2005).

The prerequisite for the three conditions aforementioned is that the listed company does not violate relevant law concerning dividends division. However, if the dividends division is involved in illegal behavior, then it can be used as a physical evidence for controlling shareholders' expropriation of the interests of small shareholders.

Was the dividends division behavior of Chihong one of the above situations? Further analyses are needed to answer the question.

5.1 Was there excessive dividend division?

To find an answer, we need to find out whether there was/were good program(s) in Chihong which urgently demanded cash. According to the temporary announcements and regular reports of Chihong during the period from December 31, 2006 to June 30, 2007, cash was badly needed in the company (see Table 4). The total amount of cash needed for the forthcoming programs would reach 700 million yuan.

Table 4 Programs needed to be carried out in the first half of 2007（million yuan）

Program name	Investment of Chihong
Establish Hulunbeier Chihong Mining Industry Co., Ltd with Yunye Group and other companies in Hulunbeier City of the Autonomous Region of Inner Mongolia	60
Establish a zinc and germanium company in Jianshui County of Yunnan Province with Yunye Group	11

(*To be continued*)

(*Continued*)

Program name	Investment of Chihong
Provide supplementary registered capital for Sanxin Company	44.20
Further invest in the Imports & Exports Co, Ltd of Yunye Group	19.53
Establish a research center	100
Establish a project with a yearly output of 30 tons of germanium	24.960
Establish a Zhaotong mineral separation factory with a daily separation capability of 2,000 tons	22.390
Total	70.823

Then compared with the cash needed, is there abundant cash flow in Chihong? Table 5 shows the differences between the net value of cash flow from the operation activity of each share and the cash dividends of every share in the past three years. We can find that in 2004 and 2005, Chihong had an abundant cash flow, which was, respectively, 3.3 and 1.5 times more than that of the cash dividends of each share. In 2006, the cash flow from the operational activity of Chihong was about twice as much as that of in 2005. However, the increase of the cash dividends for each share in the same period was even larger, with a growth of about 600% than in 2005. Thus a gap of 21.17% was created. This result indicates that Chihong's earnings in 2006 were far less than the cash dividends to be paid, not to mention the programs in Table 4. Chihong, however, still allotted a large amount of cash dividends, regardless of its serious shortage of cash, which undoubtedly triggered worries about the quality of the dividends policy of Chihong.

Table 5 Comparison between net value of the cash flow from each share's operational activities and the cash dividend of each share from 2004 to 2006 (Unit: yuan)

Year	2004	2005	2006
Net value of the cash flow from each share's operational activities	1.31	1.26	2.37
Cash dividend of each share	0.30	0.50	3.00
Differences	337.33%	151.60%	−21.17%

Besides, on April 2, 2007, Chihong held a temporary board of director meeting. The meeting approved a loan application for 600 million yuan (among it, 400 million yuan is short-term loan and the rest long-term loan) from the bank. The loan was to be used as the operational flow capital and for program construction.

Coincidently, as the total capital stock of Chihong was 195 million shares and for each 10 shares, 30 yuan cash dividend would be given to the shareholders, then a total of 585 million cash would be needed, an amount close to the total amount of loan applied. Myers (1977) and Jensen&Meckling (1976) pointed out that, under certain conditions, shareholders might expropriate the wealth of the creditors and the expropriation behavior may use excessive (also unexpected) dividend payout as the form. Shareholders can ask the company they control to reduce investment to increase dividends or ask the company to loan money for dividends financing (debt financing dividends). Under the two conditions, if creditors do not expect the behavior of the shareholders, the value of the debt market will be reduced while that of equity will be raised.

All of the evidence aforementioned indicates that there is a suspicion of Chihong's excessive dividing cash dividends.

5.2 Are the prices of the two types of share the same?

In the whole process of nontradable shares reform and tailored additional equity offering, we find that the motivation of the controlling shareholders for expropriation was comparatively obvious (especially, the phenomenon two and the phenomenon four in the fourth part) Controlling shareholders made two compromises (see Table 6). First, gave 2.7 additional shares (instead of the original 2.3 shares) for every 10 shares held and second decreased the purchase money from 801.840 million yuan to 670.950 yuan. These behaviors make us be doubtful that there is a suspicion of the shareholders of reducing the stock changes price and increasing purchase money during the preliminary planning process of nontradable shares reform with tailored additional equity offering. We can compare it to the selling behavior in the vegetable market. If the price of a certain vegetable is X and the vegetable seller ask for a price of Y（Y>X）. And then after the bargaining of the customer, the price is Z. If Z<X, the seller will not sell the vegetable. Only when Z lies in the range between X and Y, will the seller agree to sell the vegetable. During this process, the customers will never know the specific price of X. This kind of serious information asymmetry will stimulate the seller's motivation to expropriate customers' interests. This information asymmetry also makes possible expropriation feasible. Similarly, as for Chihong, its holding shareholder might use the information asymmetry to expropriate small shareholders' interest. We can assume that if the consideration for shares in the nontradable shares reform had not been increased and the purchase money had not been reduced, then what would have been the result? Even if the controlling shareholders had made two big compromises, who can guarantee that there is no expropriation of interest? Due to serious information asymmetry problem, no outsider knows exactly the bottom line (price X) of the

controlling shareholders.

Table 6 Two compromises made by the controlling shareholders

	Consideration for shares	Total amount of money needed for the purchase
Before	2.3 bonus shares for every 10 shares held	801,840,000.00
After	2.7 bonus shares for every 10 shares held	670,950,000.00
Increase(±) %	17.39%	−16.32%

In the case of Chihong, even though controlling shareholders confronted strong opposition from small shareholders and had to make two compromises, small shareholders stood no chance of knowing exactly how the interest was distributed. Since only the controlling shareholders knew the minimum level of the price, they could always stand on a more favorable position in the game. For this reason, we think that the prices (after the tailored additional equity offering was carried out) of the shares held by the controlling shareholders were still lower than the prices of the shares held by the other small shareholders. Although one of the aims of the nontradable shares reform was to eliminate this kind of difference, just like what we have discussed before that the long-term equity division in China has a far-reaching influence on shareholders with nontradable shares, this special Chinese characteristic will inevitable lead to damage to the interests of small shareholders during the process of nontradable shares reform. Depending on those strange phenomena in the process of Chihong's nontradable shares reform and tailored additional equity offering, our conclusion is that the Chihong's consideration for shares in the shares reform was unfair to small shareholders.

5.3 Responses of market concerning the division

According to the Signal Theory of Dividends, changes in dividends will trigger changes in the prices of shares since dividends carry information concerning interior personnel's judgment on the company's future development. Aharony and Swary (1980), Asquith and Mullins (1983) found from their empirical evidence that at the first time when companies issue cash dividends or intend to raise the level of their cash dividends, share prices would usually increase whereas when the companies stop issuing cash dividends or lower the level of their cash dividends, share prices would go down. Of course, this reason cannot be used to explain the phenomenon in Chihong. On the very day when the decision of dividend division was officially announced, Chihong's share experienced a high opening price and a low closing price, with a difference of about 8 yuan. Moreover, in the following 11 days, the adverse situation remained unimproved, while in the corresponding period, the composite index of Shanghai Stock Exchange increased 6.6%.

Then what is the response of the stock market concerning the largest cash dividends division in the securities history of China? We mainly review the case from the perspective of cumulative abnormal return (CAR).

The method used is as below:

(1) Calculation of the rate of return in theory (that is the normal rate of return) R'_t: R'_t is a concept in anticipation. In realistic research, there are four different calculation methods of the rate of return.

① The real rate of return of shares in the same industries. The indexes concerning daily return rate in the plate of nonferrous metals both in Shanghai stock market and Shenzhen stock market were adopted.

② The real rate of return of the market combination. Daily return rate of the composite index of Shanghai Stock Exchange was adopted.

③ The average realistic rate of return of the share in the former period. The average return rate within 150 days before a company's announcement of dividend distribution was adopted.

④ The normal rate of return decided by the risk measurement-β[7] in the system.

Because of the popularity of the Capital Assets Pricing Model (CAPM) in the past, research of similar cases was mainly focused on the abnormal rate of return after the adjustment of the risks. In recent years, there have been more and more abnormal phenomena which lead to suspicion of the risk coefficient-β in the system. Hence the abnormal rate of return after the adjustment in the market has been increasingly adopted. In this paper, we mainly used the first three methods to calculate the anticipated rate of return in theory.

(2) Accumulated average abnormal rate of return *CAR*

Daily abnormal rate of return: $AR_t = R_t - R'_t$;

Accumulated abnormal rate of return: $CAR_w = \sum_{t=0}^{W} AR_t$;

In the formula, date ranges from 0 to 15. The four windows for observation were (0, 1), (0, 3), (0, 5) and (0, 10), respectively .

CAR calculated by the above three methods are shown in Fig. 2.

[7] In CAPM, the calculation equation for R'_{it} is $R'_t = \alpha + \beta \times R_{mt} + \varepsilon_t$. Among the parameters, β is a statistical index for measuring the relationship between the two time alignments. When analyzing financial data, β is used to measure the risks of individual shares in the market.

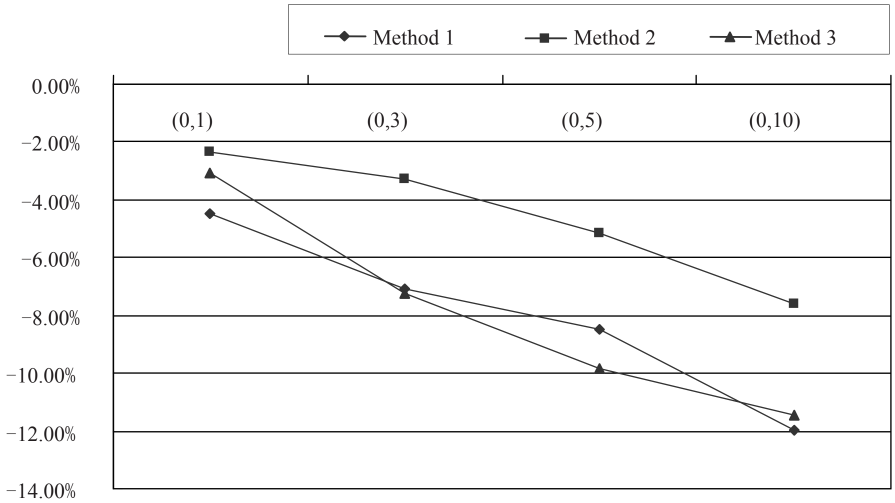

Fig. 2 CA*R* calculated by the above three methods

Results show that as for the four observation windows of (0, 1), (0, 3), (0, 5) and (0, 10), they all have negative *CARs* and there is negative response in the market, indicating that the investors fear their interest will be expropriated by the high dividend payout of Chihong, thus start to sell out their shares.

5.4 Another evidence

In Chihong's first temporary board of director meeting in 2006, three resolutions were passed: (1) The plan for the related trade concerning the purchased assets by the newly added shares in the company; (2) The new and the old shareholders share with each other the undivided profits accumulated before the company has newly added shares;[8] (3) The authorized board of directors will be totally responsible for relevant issues concerning assets purchased by newly added shares. Among the three proposals, Proposal 2 is closely related to dividends but we find that the controlling shareholders did not evade voting for the second proposal. 86.52% of the total shareholders, including both shareholders of

[8] Although this type of proposal is commonly adopted for non-tailed additional equity offering, the situation is quite different here. When this proposal was discussed concerning non-tailed additional equity offering, those potential investors didn't vote for it, which complied with relevant regulations in *Law of Company* and *Regulations for Board Meeting of List Companies* in China. By contrast, from the consideration of financing, original shareholders voted to pass the proposal of New and Old Shareholders Sharing with Each Other Undivided Profits of the Company before New Shares Are Added to the Company. Thus, it is obviously different from the present case.

nontradable shares and tradable shares, presented in the meeting who had the voting right voted for the proposal. However, according to the Article 31 in *Regulations for Board Meeting of the Listed company* (issued on March 16, 2006), when the issue being reviewed in the board meeting is relevant to the shareholders, shareholders should evade and the shares they hold, which have voting right should not be considered when calculating the votes. Then what kind of relation can be defined as the connection relation? What kind of relation exists between Yunye Group and the second proposal? It has been pointed out in the Clause 217 in the new *Company Law of the Peoples Republic of China* that the connection relation refers to the relationship between the controlling shareholders, people in charge in reality, directors, senior administrators and the company which they directly or indirectly control. Besides, the connection relation also includes the other relations which might result in the transferring of the company's profits. It can be said that the connection relation should be constrained to be the relation between the controllers or senior administrators with the company they control. Once the relation might transfer the company's assets, it can be defined as the connection relation. However, in reality, to vote for the proposal of letting new and old shareholders share with each other the accumulated undivided profits before the company has newly added shares is just to decide whether the tailored additional equity offering of 35 million shares can enjoy the accumulated profits of the company in the previous years. Concerning the dividends division policy of Chihong in 2006, this proposal was directly related to the cash dividend earnings and share dividend earnings of Yunye Group. Undoubtedly, Yunye Group is the party whose interest is connected to the proposal. Thus, Yunye Group should have evaded from voting for the second proposal.

Another important evidence we found is that during the process of the voting for the second proposal, whether the shareholders of nontradable shares have voting rights or would make a decisive difference to the final voting results. As shown in Table 7 that if votes were submitted to the nontradable shares, the proportion of being for (votes) the proposal accounted for 86.52% of the total shares which had the voting rights whereas, if votes were not submitted to the nontradable shares, the proportion of being for (votes) the proposal would drop to 56.67%. Article 4 in the *Issuing and Administration Methods for Securities of List Companies* regulates that the board meeting should give a resolution about relevant items concerning the issuing of securities and moreover, any proposal must be agreed by two thirds of the shareholders present in the meeting who have the voting right. Following this regulation, if votes were not submitted to the shareholders of nontradable shares, the second proposal, that is, new and old shareholders will share with each other the undivided profits before new shares are added to the company should not have been passed. It further means that according to the dividends division policy of Chihong in 2006, Yunye Group might have obtained a cash dividend of 105 million yuan and a total of 35,000,000 bonus shares,[9] which should not have belonged to them. This constitutes yet another evidence of controlling shareholder's expropriation of the interest of other smaller shareholders of Chihong. Considering also the conclusions in Table 5, we suspect Chihong, with good reasons, may deliberately circled and preserved its profits in the previous years[10] and after giving tailored additional equity offering, the company divided its remaining profits.

Table 7 Types of stocks and the voting result

Voting result	Shareholders of nontradable shares	Shareholders of tradable shares	Total	Nontradable Shares with voting right	Nontradable Shares without voting right
For	90,000,000	23,024,565	113,024,565	86.52%	56.67%
Against	0	5,829,599	5,829,599	4.46%	14.35%
Abstention	0	11,774,080	11,774,080	9.01%	28.98%

6 Conclusion and suggestions

Under the specific background of the nontradable shares reform in China, this paper uses agency theory to explain the dividend payout behavior of Chihong. The result of analysis shows that the practical effects of Chihong's paying the largest bonus and cash dividends in the Chinese securities history is not satisfactory. It also induces suspicion of controlling shareholder's possible expropriation of small shareholders by dividends. We found that: (1) Although planned projects of Chihong in 2007 required a total amount of cash flow of RMB 700 million yuan, its controlling shareholders still asked the company to pay larger amount of cash dividends, resulting in the fact that the net value of the cash flow from the operation activity for each share dropped to only about 80% of the cash dividends for each share in 2006. Whereas, in the past years of 2004 and 2005, the net values of the cash flow from the operation activity for each share in

[9] In 2006, Chihong implemented a dividends distribution policy of offering 10 bonus shares for every 10 shares held. Besides, for each share, there was 30 yuan cash dividend. Depending on the tailed additional equity offering of 35,000,000 stocks, Yunzhi Group obtained a cash dividend of RMB 105 million yuan.

[10] In 2004, 2005 and 2006, earnings for each share of Chihong were 0.37, 0.82 and 5.32, respectively. Obviously, in 2006, the earning of each share was 13.378 times than that of in 2004, an increase larger than the net value of the cash flow from the operational activity of each share by 48.65%.

the company were respectively 3.37 and 1.52 times larger than the cash dividends for each shared. (2) In the process of the nontradable shares reform and tailored equity offering of Chihong, controlling shareholders in the company made two compromises to smaller shareholders, including increasing consideration for shares in the nontradable shares reform and reducing purchasing price, which triggers our worry towards the nontradable shares reform in the company, for we believe that the behavior of Chihong's nontradable shares reform integrated with tailored equity offering is not proper. What is more important is that although the reform has decreased the price discrepancy between two types of shares, our analysis result shows that it is very difficult to testify that the prices of the two types of shares are the same. Serious information asymmetry caused *invisible difference* between the prices of the two types of shares. (3) Through the calculation by three methods, there is a surprising similarity in CARs. As shown in Fig. 2, the statistical lines of CASs calculated with Method 1 and Method 3 are nearly overlapping, which shows that the effect of the nontradable shares reform in the company aroused a negative response from the market. (4) According to the new *Company Law of the Peoples Republic of China* and the *Regulations for Board Meeting of List Companies* and *Administration Methods for Issuing Securities of List Companies*, Yunye Group has possibly obtained 35 million bonus shares and 105 million yuan cash dividend, which should not have belonged to it. As a result, the interest of small shareholders was seriously damaged.

Our study proves that under the background of nontradable shares reform in China, high dividend payout does not mean better protection of the investors' profit. As mentioned before, the long history of equity division in China has a far-reaching influence on Chinese nontradable shareholders. As reflected in the relationship between dividend payout and protection of investors, the principle that high dividends policy will reduce agency *cost* is not applicable in China's stock market. Compared with related transaction, controlling shareholders' usurping on small shareholders is realized through distribution of profits in cash dividend. Thus, if it does not violate certain regulations for dividend payout, even if it causes adverse influences on other shareholders, regulatory government bodies can neither interfere nor punish such kind of behavior, which makes supervision even harder.

By analyzing the case of Chihong, this paper suggests that CSRC need to take effective measures to solve the expropriation problem caused by high dividend payout. On one hand, from the perspective of investor protection, CSRC can ask listed companies to explain the reasons and references for paying excessive dividends through certain regulations and rules. Under the condition that a company cannot provide satisfactory evidence or excess dividends may have potential negative influences on the company's future development; CSRC will suggest the dividend payout be reduced. On the other hand, CSRC needs also to standardize and urge listed companies to disclose consummate and high-quality information to the small investors in the market. Especially when handling typical and influential cases, CSRC should disclose proceedings and results of these cases to the public regularly and explicitly. As the famous saying in the capital market goes, sunshine is the best preservative. Only when CSRC and listed companies thoroughly share all the information with small investors can misunderstanding and unnecessary conflicts be reduced to the minimum level.[11]

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[11] Lü and Xiao (2006) described legal protection and disclosure of information respectively as the Visible Hand and Invisible Hand for preventing expropriation behavior from the final holders.

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