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Non-Controlling Majority Shareholder Exit Threat and Corporate Governance—Evidence from Chinese Listed Companies

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Abstract: The threat of exit of non-controlling majority shareholders, as an effective form of equity governance, is playing an increasingly significant role in corporate governance. This paper empirically investigates the implications of the exit threat of non-controlling major shareholders towards corporate governance using a sample of 31,228 observations of A-share listed companies in Shanghai and Shenzhen from 2011 to 2021. The results suggest that the threat of exit from non-controlling majority shareholders contributes to the level of corporate governance. After further endogeneity analysis and robustness tests, the results reveal that the above findings still hold, validating the robustness of the empirical results. This paper reveals the corporate governance effects exerted by the exit threat mechanism of non-controlling majority shareholders, with vital insights for regulators, investors and corporate governance of companies.

1. Introduction

Equity governance, as an essential part of corporate governance, has been a hot topic in academic circles. The Chicago School's "shareholder activism" view is that, given that large shareholders do not have the problem of "free-riding" on management, they are proactive in promoting corporate governance by joining the Board (Zhu et al., 2015)[1] and negotiating with management (McCahery et al., 2016)[2] to effectively achieve their supervisory role. When oversight mechanisms are ineffective, major shareholders will issue exit threats to discipline management. Since there is a risk that short selling of shares will lead to a fall in the market value of the firm's shares, firms will endeavour to avoid exit behaviour by blockholders, so the threat of exit brings them back to the bargaining table and safeguards their rights and interests. It is thus evident that the threat of exit from non-controlling majority shareholders has, to a certain extent, had a positive effect and achieved the objective of effective participation in corporate governance.

Although there is a wealth of existing research on the governance effects of large shareholders, relatively limited research has been conducted on the issue of conflicts of interest between controlling and non-controlling large shareholders. In particular, it is relatively common in emerging capital market countries that controlling shareholders encroach on the benefits of non-controlling majority shareholders. Accordingly, it is more theoretically and practically valuable to study the governance effects of exit threats by non-controlling majority shareholders. In addition, as Western scholars have mainly explored the governance effect of the exit threat based on the first class of agency problem, it remains to be tested whether the relevant theory is still applicable to the emerging capital market where the second category of agency problem is more pronounced. Hence, it is pertinent to construct a theoretical analysis framework of the governance effect posed by the exit threat of non-controlling majority shareholders to test the validity of exit threat governance theory in the Chinese capital market. Given this, this paper examines the influence of exit threat by non-controlling blockholders on the level of governance using A-share non-financial public companies in China as the sample from 2011-2021. The findings provide evidence for the effect of exit threat by non-controlling large shareholders on corporate governance and pass the endogeneity analysis and robustness test.

The contributions would probably be primarily in the following areas. First, this essay complements and extends existing research on theories related to shareholder activism, with an expansion of research related to exit threats. Secondly, the paper provides policy insights with regard to the importance of non-controlling majority shareholders and shareholding structure. Companies should actively guide non-controlling majority shareholders to engage in corporate governance and further optimise their governance structure as well as their shareholding structure. Furthermore, the government and relevant institutions should also intervene actively to fully guide and leverage the incentive effect of the exit threat from non-controlling blockholders on corporate governance.

2. Literature review and theoretical hypothesis

The exit threat effectively improves corporate governance as a way for large shareholders to play a role in corporate governance. Studies have mostly inherited and developed the Chicago School's "shareholder activism", which suggests that large shareholders can exert their power of corporate governance through positive constraints and scrutiny.

According to the signalling theory, majority shareholders, as the dominant party in terms of information, are capable of conveying negative signals to the capital market through their exit behaviour, thereby influencing share prices for corporate governance purposes. As the exit behaviour of large shareholders may threaten the value of the firm, large shareholders enable management to reconsider management decisions through the threat of selling their holdings (Dou et al., 2018[3]; Ding et al., 2022[4]). Moreover, according to Xu et al. (2022)[5], the threat of large shareholder exit increases the probability of executive change and acquisition of the firm, which can affect the firm's share price as well as market performance. It also alleviates the agency problem that management seeks self-interest (Hope et al., 2017[6]). Dou et al. (2018)[3] also find that large shareholders use the threat of exit to impact management decisions, such as reducing the level of true corporate surplus management, thereby promoting the quality of corporate financial reporting.

The above governance effects of exit threat become more pronounced especially when firms have multiple large shareholders or when stocks are more liquid. Empirical studies have been conducted to interpret that the threat of large shareholder exit would add value to the company and generate excess market returns from a liquidity perspective (Helling et al., 2020[7]; Drobetz et al., 2021[8]). Non-controlling large shareholders have a stronger incentive to engage in corporate governance since they hold a larger proportion of shares whose market value of this stock is determined to a large extent by the state of performance and operations of the business. Non-controlling majority shareholders improve governance via two main modes of behaviour: supervision and exit. They can exercise effective oversight and intervention by participating in the processes of corporate governance, for instance, they may attend the management change proposal. Whereas the exit behaviour of non-controlling large shareholders often implies an unfavourable signal that the company is under-valued.

This is often interpreted by the market as negative information and results in a significant drop in share price, to the detriment of insider shareholders and management. Controlling shareholders and management will prevent exit behaviour by non-controlling majority shareholders, if possible, which means that the exit threat from non-controlling blockholders, as an in-between approach, also serves an important governance role. There is a supervisory and restrictive effect of the threat of exit from the non-controlling shareholder on the controlling shareholder and management, fulfilling its governance function through shaping management decisions. In light of the above analysis, the hypothesis put forward in this paper is as follows:

The threat of exit by non-controlling majority shareholders can enhance corporate governance.

3. Research design

3.1 Data sources and sample selection

In this article, all listed companies in China A-shares from 2011-2021 are chosen as the initial sample. By excluding the sample of enterprises in the financial field, the sample of enterprises with absence values, the sample of ST and *ST, and the sample of companies with abnormal relevant data, a total of 4,475 companies with 31,228 valid observations are finally obtained. The research data are principally derived from Wind China Financial and CSMAR Database. The paper applies a Winsorize at the top and bottom 1% for all continuous variables to eliminate the impacts of the extremes.

3.2 Definition of variables

3.2.1 Response variable: level of corporate governance (*Governance*)

Referring to the method of measuring corporate governance capacity by Zhou et al. (2020)[9], based on the seven indicators selected from the three aspects of incentive, supervision, and decision-making, the first principal component obtained from the principal component analysis is taken as the composite indicator reflecting the level of corporate governance (*Governance*). Due to the limitations of space, the table is not shown.

3.2.2 Explanatory variable: non-controlling majority shareholder exit threat (NET)

This article defines non-controlling majority shareholders as those with a shareholding greater than 5%. Based on the method of Chen (2019)[10] to quantify the exit threat of non-controlling majority shareholders, *NET* is defined as the product of stock liquidity *StkL* and the degree of competition of non-controlling majority shareholders *NCMEC*, with the average daily outstanding stock turnover rate used as a measure of stock liquidity, where *NCMEC* is measured as below:

$$NCMEC_{it} = \sum_{k=1}^{n} \left(\frac{NCMS_{k,i,t}}{TPMS_{i,t}} \right)^2 \tag{1}$$

where $NCMEC_{it}$ denotes the degree of competition among the non-controlling majority shareholders of firm i in year t, $NCMS_{k,i,t}$ denotes the shareholding of the kth non-controlling majority shareholder of firm i, and $TPMS_{i,t}$ denotes the sum of the shareholdings of all majority shareholders of firm *i* in year *t*.

Based on the above calculations, the final model for calculating the threat of exit *NET* from the non-controlling majority shareholders is derived as follows:

$$NET_{it} = StkL_{i,t} \times NCMEC_{it} \tag{2}$$

3.2.3 Control variables

Regarding the studies by Chen (2019)[10] and Zhou et al. (2020)[9], the following control variables are identified here: firm size *Size*, gearing ratio *Lev*, return on assets *ROA*, fixed asset ratio *FIXED*, board size *Board*, equity concentration *Top1*, Tobin's Q *TobinQ*, and nature of equity *SOE*. Additionally, this paper controls for annual and industrial fixed effects. The definition of variables is presented in Table 1.

Table 1: Definition of variables

Variables	Description	Measurement
Governance	Corporate governance level	See 3.2.1
NET	Non-controlling large shareholder exit threat	See equation (2) in 3.2.2
Size	Size of company	ln(Total assets)
Lev	Gearing ratio	Total liabilities divided by total assets
ROA	Return on assets	Net profit divided by total assets
FIXED	Fixed asset ratio	Fixed assets divided by total assets
Board	Board size	ln(Board size)
Top1	Shareholding of the top stockholder	Shares held by the 1st majority stockholder divided by the aggregate number of shares
TobinQ	Tobin's Q	(Market value of shares outstanding + Number of non-marketable shares × Net assets per share + Book value of liabilities) / Total assets
SOE	Nature of shareholding	State-owned enterprises take the value of 1; otherwise, 0.

3.3 Main model

To test the relation between the threat of exit by non-controlling majority shareholders and the degree of corporate governance, the following model is constructed:

$$\begin{aligned} Governance_{it} = {} & \alpha_0 + \alpha_1 NET_{it} + \alpha_2 Size_{it} + \alpha_3 Lev_{it} + \alpha_4 ROA_{it} + \alpha_5 FIXED_{it} + \\ & \alpha_6 Board_{it} + \alpha_7 Top1_{it} + \alpha_8 TobinQ_{it} + \alpha_9 SOE_{it} + \sum Year_{it} + \sum Indu_{it} + \varepsilon \end{aligned} \tag{3}$$

where NET_{it} indicates the exit threat of non-controlling majority shareholders of the company *i* in year *t*. If the regression coefficient α_1 of NET_{it} is significantly positive, it means that the exit threat of non-controlling majority shareholders acts as a proactive force on the level of corporate governance, i.e., it can prove the research hypothesis of this paper.

4. Empirical results and analysis

4.1 Results of descriptive statistics

Table 2 illustrates the descriptive statistics for all variables in the model. The maximum of exit threat is 0.016, the minimum is 0 and the average value is 0.001, suggesting that there is some variation in exit threat across firms. The average value of corporate governance water is 0.069, the value of maximum is 2.450 and the minimum value is -2.399, with a standard deviation of 0.002, indicating that there remains some potential for enhancement in the level of governance of listed corporations.

Table 2: Descriptive Statistics

Variable	N	Mean	Std. Dev	Min	Max
Governance	31228	0.069	1.016	-2.399	2.450
NET	31228	0.001	0.002	0	0.016
Size	31228	22.150	1.285	19.520	26.430
Lev	31228	0.415	0.207	0.031	0.925
ROA	31228	0.042	0.068	-0.398	0.254
FIXED	31228	0.204	0.156	0.002	0.725
Board	31228	2.121	0.197	1.609	2.708
Top1	31228	0.341	0.147	0.081	0.758
TobinQ	31228	2.059	1.433	0.802	17.73
SOE	31228	0.316	0.465	0	1

4.2 Correlation analysis

The Pearson correlation between all the variables is displayed in Table 3. The correlation coefficient between exit threat and level of corporate governance is 0.104, whose significance level is 1%, tentatively judging a positive correlation between the two variables and preliminary verifying the hypothesis. The absolute value of the correlation coefficient between the control variables is small, signifying that the correlation is weak and there is no problem of multicollinearity.

Table 3: Pearson (Lower Triangle) correlation

	Governance	*NET*	*Size*	*Lev*	*ROA*	*FIXED*	*Board*	*Top1*	*TobinQ*	*SOE*
Governance										
NET	0.104 ***									
Size	-0.501 ***	-0.143 ***								
Lev	-0.327 ***	-0.103 ***	0.528 ***							
ROA	0.111 ***	0.058 ***	-0.112 ***	-0.445 ***						
FIXED	-0.148 ***	-0.055 ***	0.048 ***	0.055 ***	-0.094 ***					
Board	-0.651 ***	0.048 ***	0.243 ***	0.147 ***	-0.032 ***	0.122 ***				
Top1	-0.207 ***	-0.311 ***	0.128 ***	0.032 ***	0.126 ***	0.072 ***	-0.002			
TobinQ	0.173 ***	0.083 ***	-0.510 ***	-0.364 ***	0.251 ***	-0.069 ***	-0.159 ***	-0.146 ***		
SOE	-0.515 ***	-0.151 ***	0.351 ***	0.289 ***	-0.181 ***	0.147 ***	0.257 ***	0.217 ***	-0.235 ***	

4.3 Regression and additional tests

4.3.1 Regression

Column (1) of Table 4 presents the regression result of the multiple linear regression of exit threat and level of corporate governance. According to the result, the regression coefficient between the exit threat of non-controlling majority shareholders and the level of corporate governance is 19.375 which is significant at the 1% level, i.e., the exit threat is positively correlated to the degree of corporate governance. This points out that the stronger the exit threat of the non-controlling majority shareholder, the higher the level of corporate governance, further validating the hypothesis.

4.3.2 Endogenetic analysis

To avoid the problem of sample selection bias, this essay employs the Propensity Score Matching (PSM) method to conduct matching tests at a ratio of 1:3, where the matched variables are all control variables for the main regression and they pass the balance test. The results of the regression using the matched sample are displayed in column (2) of Table 4 and are in line with the previous regression results, with the regression coefficients still significant at the 1% level, indicating robust models.

Table 4: Regression and endogeneity analysis

	(1)	(2)
	Main regression	Endogeneity analysis
Variables	*Governance*	*Governance*
NET	19.375***	19.776***
	(17.52)	(16.22)
Size	-0.194***	-0.200***
	(-41.21)	(-39.30)
Lev	-0.147***	-0.145***
	(-7.09)	(-6.48)
ROA	0.161***	0.157***
	(4.10)	(3.69)
FIXED	-0.220***	-0.203***
	(-8.06)	(-6.84)
Board	-2.530***	-2.555***
	(-138.76)	(-128.44)
Top1	-0.314***	-0.325***
	(-10.11)	(-9.61)
TobinQ	-0.083***	-0.085***
	(-39.91)	(-37.43)
SOE	-0.409***	-0.418***
	(-33.50)	(-32.21)
Constant	10.387***	10.601***
	(76.49)	(72.74)
Observations	31,228	26,551
Year FE	YES	YES
Industry FE	YES	YES

z-statistics in parentheses
*** p<0.01, ** p<0.05, * p<0.1

4.3.3 Additional test

1) Consider the lag effect.
Considering the possible lagged effect of exit threat on corporate governance, the paper reperforms

the regression after a one-period lag of exit threat *NET*. According to column (1) of Table 5, the regression coefficient is still significantly positive at the 5% level with a value of 4.1022, pointing to the robustness of the experimental results.

2) Add other control variables.

The regression is rerun after adding three control variables namely *BM* (book-to-market ratio), *Indep* (proportion of independent directors) and *Mshare* (percentage of management shareholding). Again, the regression results are significant at the 1% level. There is no significant change in the results as evidenced by column (2) of Table 5, demonstrating the robustness of the empirical outcomes.

Table 5: Robustness tests

	(1)	(2)
	Lag effect	Add control variables
Variables	Governance	Governance
NET	7.238***	18.772***
	(4.81)	(21.16)
Size	-0.183***	-0.175***
	(-34.65)	(-48.10)
Lev	-0.111***	-0.016
	(-4.88)	(-1.01)
ROA	0.054	-0.148***
	(1.30)	(-4.65)
FIXED	-0.160***	-0.136***
	(-5.23)	(-6.47)
Board	-2.566***	-1.776***
	(-130.21)	(-106.05)
Top1	-0.449***	-0.623***
	(-13.04)	(-27.36)
TobinQ	-0.075***	-0.064***
	(-32.83)	(-38.39)
SOE	-0.403***	-0.181***
	(-30.71)	(-20.21)
BM		0.022***
		(8.34)
Indep		4.643***
		(87.65)
Mshare		2.110***
		(122.40)
Constant	10.166***	6.033***
	(63.33)	(57.57)
Observations	25,720	30,773
Year FE	YES	YES
Industry FE	YES	YES

z-statistics in parentheses
*** $p<0.01$, ** $p<0.05$, * $p<0.1$

5. Conclusion

Exit threat as one of the approaches to shareholder participation in corporate governance has received widespread attention from academics and industry, and in particular, theoretical studies on the corporate governance effects of exit threat exercised by non-controlling blockholders have gradually advanced for the past few years. Based on the emerging capital market in China, this research empirically examines the influence of the threat of exit by non-controlling majority shareholders on corporate governance taking A-share public companies in Shanghai and Shenzhen from 2011 to 2021 as the sample for the study. The regression results show that the threat of exit by non-controlling blockholders has a positive corporate governance impact. Meanwhile, the conclusion still holds after the endogeneity analysis of the model and two robustness tests.

Following the above studies, there are some findings below.

First, this paper supplements and extends existing research. Previous research has focused on the corporate governance role of exit threats and there has been less discussion of theoretical perspectives on shareholder activism in the context of emerging capital markets. This paper provides empirical evidence on the corporate governance effects of exit threats by non-controlling blockholders based on the background of the Chinese emerging capital market. The paper provides policy insights concerning the significance of non-controlling majority shareholders and shareholding structure. Firms should emphasise the corporate governance responsibilities of non-controlling majority shareholders. In other words, enterprises should actively guide non-controlling majority shareholders to attend corporate governance and further improve the corporate governance structure.

Next, enterprises with an overly concentrated shareholding structure and without a non-controlling majority shareholder should actively reform their existing shareholding structure. By introducing non-controlling majority shareholders, the governance structure and shareholding structure should be further optimised to alleviate the agency problems caused by over-concentration of shareholding. For those enterprises where non-controlling majority shareholders already exist, enterprises should attach more weight to the decision-making opinions of non-controlling majority shareholders, safeguard their right to be informed of major decisions and guide them to further engage in corporate governance so that the governance effect of their exit threat can be fully utilised.

Furthermore, the government and relevant institutions should also actively intervene to fully guide and bring into play the incentive impact of the threat of exit from non-controlling stockholders on corporate governance. The authorities should improve the regulations related to the reduction or exit of major shareholders of listed companies, cut the cost of securities transactions, and improve the liquidity of stocks, thereby establishing a good institutional foundation for the threat of exit from non-controlling stockholders. Simultaneously, relevant government departments should also strengthen the protection, education and guidance for individual investors and institutional investors.

Finally, this paper mainly confirms the function of the exit threat in promoting governance of the businesses, but the mechanisms involved need to be further explored in depth. Beyond this, the theoretical framework of the role of the exit threat in corporate governance can be improved through an in-depth study of the influence of the exit threat on corporate irregularities, the quality of accounting information, etc.

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