Research on the “Double-Edged Sword Effect” of Cross-Shareholdings in China*

Xiaoyan WANG1, Jiurong SONG1, Chris Deeley2
1School of Commerce, Tianjin University of Commerce, China, 300134
2School of Accounting & Finance, Faculty of Business, Charles Sturt University, Australia
Email: dkij2007@126.com, 651483120@qq.com, cdeeley@csu.edu.au

Abstract: As the ownership structure of companies becomes increasingly complex, companies in China are entering a high incidence period of mergers and acquisitions. Means and methods of capital raising and deployment are developing rapidly, leading to increasing challenges for securities markets supervision and capital management. Cross-shareholdings are not only a form of capital structure but also an increasing means of corporate expansion in China. The increasing role of cross-shareholdings in China’s economic development and the concomitant challenges for securities markets supervision creates a rich and necessary field of academic research. This paper examines a selection of previous studies to identify, discuss and summarize positive and negative effects of cross-shareholdings.

Keywords: Cross-shareholdings; double-edged sword effect

1 Introduction

The phenomenon of cross-holdings in our country was formed in the 1990s, and its influence on the capital market has not caused the people enough attention. However, since the Asian financial crisis, the long-term economic depression and recession of Japanese economy, as well as series of explosion triggered the crisis because of "mine" in Taiwan's stock market, which makes people have a further understanding of the positive and negative impacts about cross-shareholdings. Chen (2007) considers that cross-shareholding is a double-edged sword and has pros and cons. Ran (2011) thinks that cross-shareholding has its particularity, for it may not only contribute to the development of the company but also become a death tool for company. Therefore, the further research of cross-shareholdings has become necessary. This paper is on the basis of reading a lot of domestic and international literature, elaborating the content and forms of expression of cross-shareholdings, and then analyzed positive and negative effects of the cross-holdings. Finally, the article makes a summary.

2 The content and forms of cross-shareholdings

Cross-shareholdings that originated from the translation about Cross-ownership or Cross-holding in Anglo-American law, Wechseloteitigo Beteiliguo in German law and participate reciproque in French law. We can also call it "mutual investment" or "mutual capital participation", but our country is now generally used as cross-shareholdings or cross-holdings.

Cross-shareholdings is mainly refers to a phenomenon that different companies share each other for some special purposes. We can understand from the following two aspects. On one hand, cross-shareholdings as a kind of strategy for the companies' development can be a strong purpose. This purpose may have a negative impact on other companies, but it may also produce a win-win results. On the other hand, the company take a certain way in order to achieve the purpose, namely the company achieve it by hold shares each other through mutual investment.

With the increasingly frequent phenomenon of cross-shareholdings in China's listed companies or unlisted companies or both, its form is also increasingly showing diverse and complex. According to whether there is a correlation between companies or not, cross-shareholdings can be classified into two kinds: one is vertical, the other is horizontal. The former mainly refers to the parent company's shares held by each other, and the latter refers to the number of company's shares held by each other, but there is no mother-child relationship between these companies. If according to the structural features of cross-shareholdings, the cross-shareholdings can be divided into two kinds and divided into five specific classes. First, the direct-type cross-shareholding is a lot of companies' shares directly held by each other, which is the most basic type of cross-shareholdings, and it is also called pure cross-shareholdings. Second, the direct-type cross-shareholding is a lot of companies' shares held by them among the end to end to form the complex cross-holdings type, which is based on the basis of the direct-type cross-shareholding, and can be divided into four specific kinds: linear, ring, radiation type, mesh type. In real life, the expression form of cross-shareholdings is...
not necessarily one of the five types, and it may be the mix of several types, showing more complex forms.

3 The positive effects of cross-shareholdings

3.1 Against hostile acquisitions and mergers among companies

One of the strengths of cross-shareholdings is that it can stabilize the companies' right to operate, engaged in operating, investing and financing activities with a more long-term view. It can make the companies' shares focus on the hand of enterprise group which formed as a link to cross-shareholding, which can against hostile acquisitions and mergers and protect the company's right to operate and control successfully. If when the companies meet the m&a (acquisitions and mergers) but have no cross-shareholdings, managers have to follow the needs of investors, engaged in the pursuit of short-term profits in order to avoid shares sell-off because of the reduction in profits. However, if the mutual shareholding companies meet the m&a, the mutual shareholding companies will be combined with each other and compete with hostility purchaser, increasing the cost and risk of the m&a so that the purchaser can't easily take action.

Therefore, moderate cross-shareholdings between companies can enhance inter-company alliances and cooperation, stabilize the company's ownership structure, and effectively prevent other companies' hostile m&a behavior. Some Japanese companies' success could be attributed to this partly before the 80s. The study of Sheard (1989), Morck and Nakamura (1999) also further confirms that the cross-holdings will help to resist hostile m&a.

3.2 Promote advantage joint of companies' economic resources, forming a positive synergy

If a company wants to stand out in the fierce competition and development, the company must have its own unique business model and economic resources. If the cross-shareholdings companies have their own advantages, then the cross technology complementary, information sharing, financial transactions, personnel resources and the operation of an integrated production and marketing between the companies due to cross-shareholdings can be shared between the companies, thereby enhancing the efficiency of capital, increasing the competitiveness of the companies, which is beneficial to the company's long-term development. The study of Chu (2001) indicates that cross-shareholdings can form the advantage joint of economic resources, which is mainly refers to companies' profitability grow significantly and performance improve obviously after the mutual shareholding, and then forming a positive synergy. Since China's first case of cross-shareholdings, the cross-shareholdings between Liao (LiaoNing ChengDa) and GF Securities in 1998, Liao makes most use of various kinds of economic resource advantages of GF Securities, and actively explore, promoting the performance of Liao increase significantly, which also well confirms this view.

3.3 Strengthen strategic alliances, and share the risk

Strategic alliance is that more than two or two companies or multinational companies in order to achieve a common strategic target take the joint action about the mutual cooperation and sharing of benefits and risks. Companies hold shares each other can form the interests of the community that take stock as a link, forming a solid strategic alliance so that the company can depend on each other and mutual restraint. The Cross-shareholdings companies will cooperate with each other to create value, diversify risk in order to reach the common goal and achieve common interests. Amundsen and Bergman (2002) found that the cross-shareholdings can become evidence of improving price monopoly and obtaining monopoly profits by the companies through researching cross-shareholdings behavior. In addition, the Sun TV and sina.com achieve the cooperation in business through cross-shareholdings in 2001. In short, the cross-shareholdings can effectively strengthen cooperation between companies, to achieve the pattern of "You have me, I have you" (LiQingYuan, 2010), so as to achieve common strategic goals of the cross-shareholdings companies.

4 The negative effects of cross-shareholdings

4.1 Increase capital virtually, violate the principle of capital real

Capital real is the basic principles of the contemporary company, including three specific principles: capital sure, constant capital and capital maintenance. In fact, the essence of cross-shareholdings is that the companies hold their own shares. Although the capital of each cross-shareholdings company has increased in form, there is only a stream of funds between companies in circulation actually. The fund is equivalent to double or even several times, but in essence the capital is the original one and has not increased, resulting in increasing virtually of the company's capital and the result of hollowing-out of capital (Wang, 2003). In real life, whether two-ways reinvestment or one-way reinvestment, all can possible appear the phenomenon of capital increasing virtually. In addition, it will inevitably produce real shareholders' equity dilution effect because of each company's capital increasing virtually, that the shares proportion of the company's real shareholders decline in the total shares, and voting rights also will be diluted.

4.2 Joint exclusive, engaged in monopoly or some behaviors about restrict competition
Cross-shareholdings not only can form stable alliance against hostile m&a but also may form monopoly, which is disadvantageous to absorb external capital and advanced technology. Especially enterprise group formed by cross-shareholdings may lead to the xenophobic, anti-competitive business practices between the enterprise group companies. For example, it is hard for foreign capital to enter Japan enterprise network. If the companies have a competitive relationship with each other, then companies are more likely to implement joint actions to manipulate the market yield or price, and reap monopoly profits prompting by the common goal of maximizing profits. Reynolds and Snapp (1986) found that in the replacement market if two rival companies decide cross-shareholdings, the two companies' price and profits have increased, then the company's output will be reduced, and correspondingly the consumer surplus will be low in the market equilibrium comparing to not exist cross-shareholdings relationship after comparing the similarities and differences in the product market equilibrium whether existing the relationship about cross-shareholdings or not.

4.3 Distort the company's normal governance structure

In the ownership structure of cross-shareholdings the company's governance structure has been distorted to some extent. The general meetings of shareholders, board of supervisors are hollowed out and largely invisible. The restriction mechanism between all agencies is not effective, and in fact the business operator controls the whole company. In addition, the legal person of cross-shareholdings shareholders becomes the company's important shareholders, which weakened the other shareholders' position and influence in the company. La Porta (1999) pointed out that the controlling shareholders can improve their control power to the company through cross-shareholdings, and then realize substantial control to the company with less cash flow, which cause a strong incentive to harm small shareholders' interests, and then restrain investment enthusiasm of the potential investors. What's more, the study of Wang (2002) also confirmed that the cross-shareholdings can lead to imbalance of corporate governance mechanism, conspiring to overreach restriction mechanism of company governance, so that the company's governance structure is in a distorted state.

5 Conclusion

"While water can carry a boat, it can also overturn it". Cross-shareholdings have a lot of positive impacts, but the opportunistic utilize the good system, and then it may have negative effects to society. For example, the cross-shareholdings can contribute to internal control, distorting the governance structure, but it may also have a positive impact on corporate governance. Ramseyer (1998) pointed out that cross-shareholdings can effectively limited moral hazard of the company's management after studying the cross-shareholdings phenomenon prevailing in Japanese company. The research of Morck (1999) showed that the cross-shareholdings not only improve the ability of managements to respond to outside interference, but also can improve the self-protection capabilities of managements.

The facts prove that the cross-shareholdings is a double-edged sword. In practice, we should take the benefit and avoid the harm. What's more, we should not blindly apply, expanding the positive influence of cross-shareholdings, ignoring the negative impact of cross-shareholdings. We ought to first refer to the experience of mature markets, and establish a more complete institutional system.

References