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Examining the Association between Political Connectedness and the Stock Returns of Egyptian Listed Firms

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Abstract:

This study aims at investigating the association between political connectedness and the stock returns of Egyptian firms listed in the Stock Exchange. Politically connected firms usually have either a major shareholder or a top officer who is also a member in a political body, or the firms that have state ownership, or contribute to political campaigns, in order to rationalize investors and analysts' decisions. We use Ordinary Least Squares (OLS) regression to analyze panel data for a sample of non-financial EGX30 listed firms over the period 2005–2014. Results show no significant association between political connections through major shareholders, top officers, and state ownership and stock returns of Egyptian firms listed in the Stock Exchange.

Keywords: *Political Connectedness, Stock Returns, Egyptian Stock Exchange*

1/ Introduction:

Political connectedness, thereafter political connections, of business entities has attracted massive attention due to the profound impact government policies have on the firm performance. Firms take various steps to strengthen their relations with senior government officials and politicians. These steps may include businessmen's support for political candidates in implementing their electoral plans and programs, as well as serving on the firms' boards of directors (Adhikari et al., 2006; Faccio, 2006). Recently, literature provides some evidence that political connections within the boards of directors have become very widespread (Goldman et al., 2009).

It should be noted that prior studies have investigated different types of political connections, depending on the nature of the relationship between firms and politicians. Due to these studies, a firm is identified as being politically connected if:

1- At least one of its major shareholders (controlling at least 10% of voting shares) is a member of the parliament, a minister, or is closely related to a top politician or party (Johnson and Mitton, 2003; Faccio, 2006; Faccio et al. 2006; Faccio 2010).

2- At least one of its top officers (CEO, president, vice-president, chairman, or secretary) is a member of parliament, a minister, or is closely related to a top politician or party (Johnson and Mitton, 2003; Faccio, 2006; Faccio et al. 2006; Goldman et al. 2009; Faccio 2010).

3- It has state ownership (Polsiri and Jiraporn, 2012; Liu, 2012).

4- It contributes to political campaigns (Cooper et al., 2010; Narayanaswamy, 2013).

Accordingly, some of the earlier studies have attempted to illustrate the advantages that the politically connected firms can be characterized over the other

non-politically connected firms. These firms may benefit from easy access to debt financing, reducing taxes, and a monopoly of some important industries (Johnson and Mitton, 2003; Cull and Xu, 2005; Dinç, 2005; Khwaja and Mian, 2005; Adhikari et al., 2006; Faccio et al., 2006; Li et al., 2008; Claessens et al., 2008). They also manage to get lucrative government contracts (Boubakri et al., 2012; Goldman et al., 2013; Tahoun, 2014), as well as they are characterized by regulatory protection and reducing the prosecution against them through making use of their political relationships (Chaney et al., 2011).

In addition to the exploitation of economic resources for their own interests at the expense of other competitors, firms can get such rewards as receiving subsidy for the energy that can be obtained by these firms and utilizing the lands of the state (Diwan et al., 2015), and protecting their firms from competitors; as occurred in Tunisia; where the officials in the former Tunisian regime took advantage of government regulations by adding new legislations to serve the interests of firms connected with the Tunisian ex-President Zine El Abidine Ben Ali and his family and other close persons and protect them from competition. Some of these added legislations was making preconditions for licensing and restrictions on foreign direct investment (FDI), which led the firms that politically connected with the Tunisian ex-President and his family to obtain more than one fifth (21%) of the private sector's net profits (Rijkers et al., 2014).

The remainder of the paper is organized as follows. Section 2 reviews prior literature and develops the hypotheses. Section 3 introduces the research design and describes the data and sample. Section 4 discusses the empirical results. Finally, section 5 concludes.

Literature Review:

The study of Johnson and Mitton (2003) has aimed at evaluating the impact of capital controls policy (constraining financial flows across borders) in September 1998 in Malaysia after the Asian financial crisis on the stock returns in politically connected firms and other non-politically connected firms. These politically connected firms are connected with government officials; Mahathir Mohamad (Prime Minister and the President of the United Malays' National Organization (UMNO) since 1981), Daim Zainuddin (who was Finance Minister early in Mahathir's term and he was closely allied with Mahathir), and Anwar Ibrahim (the Deputy Prime Minister with a personal friendship with Prime Minister Mahathir). The results of this study indicated high stock returns after September 1998, where the estimated profit of the firms connected with Prime Minister Mahathir was about $ 5 billion.

The study of Faccio (2006) included an international sample of 20,202 publicly traded firms in 47 countries during 1997 to 2001. It concluded that there is an increase in cumulative abnormal returns[1] (CAR) on the dates of announcement that one of the major

1 Abnormal returns are the part of its returns that are uncorrelated with average stock-market developments, which are calculated through the difference between the actual returns and expected returns (Coulomb and Sangnier, 2014, P. 159).

shareholders or one of the officials of the firm would run for the elections or one of the politicians would be a member in the firm's board of directors.

Moreover, Goldman et al. (2009) study included a sample comprised the biggest S&P 500 companies in the United States, sorted into those connected to the Republican Party and those connected to the Democratic Party, after the Republican win in the 2000 Presidential Election. This study found that there was an increase in CAR of shares in the companies connected politically to the Republican Party; while shares' CAR were low in the other companies connected politically to the Democratic Party.

Finally, Liu et al. (2012) aimed at examining the relationship between political connections in firms through top officials and state ownership and the stock returns in China in the long term, furthermore, Civilize et al. (2015) aimed at measuring the impact of political connections in firms through major shareholders and top officials on stock returns in Thailand in the long term. They found higher stock returns in the politically connected firms than the other non-politically connected firms in the long-term, particularly in the more competitive and most regulated industries, such as Financials, Property and Construction, Resources and Technology.

Studies that address the negative association between firm political connections and stock returns:

Fisman (2001) aims at evaluating the CAR of shares among the traded firms in the stock market of Indonesia, and to what extent they were affected by the bad news surrounding the health situation of the former Indonesian President Suharto during 1995 to 1997. The study has found a reduction in abnormal returns in the firms connected to the former President Suharto, because of the bad news of his health. Whereas the previous abnormal returns in the firms connected politically to the President were higher than the other non-politically connected firms by 23% before this news.

In addition, Leuz and Oberholzer-Gee (2006) study concluded that the politically connected firms lose value when the regime - that those firms connected to- fails. Therefore, the investments in politically connected firms may be risky, thus the regime change may have negative impact on stock returns in politically connected firms in the long term.

Some other studies also concluded that abnormal returns of shares in the politically connected firms were less than other non-politically connected firms in the long term, because Firms with political connections may provide misleading information or eliminate material facts in the documents submitted to the organizational committee of the stock market, as they are more likely to involve in law- breaking activities, such as falsification of financial statements to be able to obtain approval for Initial Public Offerings (IPO) (Fan et al., 2007; Li, 2013).

Based on the previous discussion, there is no agreement between the results of these studies about the nature of the relationship between the political connections in firms and stock returns, which made the nature of this relationship questionable. Therefore, it is possible to measure the impact of political connections on stock returns in

firms listed in the Egyptian Stock Exchange, to reach the strength and direction of this relationship in order to rationalize the investment decisions, and to rationalize the other stakeholders' decisions.

2/2 Hypotheses Development:

Civilize et al. (2015) argued that the political connections represent an important determinant of stock returns in many developing stock markets worldwide. Accordingly, it is necessary to test whether firms with political connections have achieved higher stock returns, and indicate whether different types of political connections play the same role on stock returns. One of the literature streams addressed the political connections through major shareholders (e.g. Faccio, 2006; Civilize et al., 2015). Another stream of literature investigated political connections through top officers (e.g. Faccio, 2006; Fan et al., 2007; Goldman et al., 2009). Final stream emphasized the importance of state ownership, as one of the political connections forms (e.g. Liu et al., 2012).

This study aims at exploring the association between political connections and the stock returns of firms listed in the Egyptian Stock Exchange. To achieve this objective, the following hypotheses are conjectured:

- H_1: There is a significant relationship between political connections through major shareholders and stock returns.
- H_2: There is a significant relationship between political connections through top officers and stock returns.
- H_3: There is a significant relationship between political connections through state ownership and stock returns.

Research Design:

3/1 Data and Sample Selection:

The initial sample of includes the most actively traded 30 firms included in the EGX30 index, as of 31/1/2015. We exclude 7 financial institutions due to their different reporting characteristics, in addition to another 4 firms as their fiscal year ended in a date other than 31/12. Hence, the final sample consists of 19 firms, for ten years. Thus, the final sample consists of 152 firms-year observations during the period 2005-2014.[2]

The financial data and political connections data needed to test the relationship between political connections and stock returns are obtained from the annual reports that are available at the Egypt Mubasher website[3] and the Egyptian Company for Information Dissemination (EGID); a subsidiary of the Egyptian Stock Exchange. We relied on Bloomberg database to obtain firm stock returns.

3/2 Variables Measurements:

3/2/1 Dependent Variable: Stock returns (R_{it}): is the dependent variable of the three models. Following Liu et al. (2012, P. 817), we compute R_{it} as:

$$R_{it} = (P_{it} - P_{it-1} + D_{it}) / P_{it-1}$$

Where, P_{it} is the closing price of firm i's stock in year t. D_{it} is the dividend of firm i in year t.

[2] It should be noted that 38 observations are excluded due to non-availability of data.

[3] Available at: *www.mubasher.info/countries/EG*

3/2/2 Independent Variables: $PCON_1$; $PCON_2$; and $PCON_3$.

$PCON_1$: is a dummy variable that takes a value of 1 when the firm has major shareholder who is a politician or through a relative. A relative may be a spouse, child, sibling, or parent, and 0 otherwise. [4]

$PCON_2$: is a dummy variable that takes a value of 1 when the firm has top officer who is a politician or through a relative, and 0 otherwise.

$PCON_3$: is a dummy variable that takes a value of 1 when the firm has state ownership and 0 otherwise.

3/2/3 Control Variables: the control variables are specified as follows:

Audit Quality (AQ): is a dummy variable that takes a value of 1 for firms with Big 4 auditors, and 0 otherwise.

Firm Size (S): is measured by the natural logarithm of total assets at the end of the year.

Return on Assets (ROA): the ratio of net income to average total assets.

Market to Book Value (MtB): is measured by (market price of share) divided by (shareholders equity divided by number of ordinary shares outstanding).

Leverage (LEV): is measured by long-term debt divided by total assets.

Sales Growth (Growth): is measured by sales revenues in year *t* minus sales revenues in year *t-1* divided by sales revenues in year *t-1*.

Industry: (Indust): is a dummy variable that expresses the sector's type where the firm = 1 if it is Telecommunications, 2 if it is Basic Resources, 3 if it is Industrial Goods and Services and Automobiles, 4 if it is Construction and Materials, 5 if it is Real Estate, 6 if it is Food and Beverage, and 7 if it is Personal and Household Products.

Financial crisis (Crisis): is a dummy variable that expresses the financial crisis that takes a value of 1 for firms during the period from 2007 to 2009, and 0 otherwise.

Revolution (Rev): is a dummy variable that expresses the effect of the Revolution. It takes a value of 1 for firms during the period from 2011 to 2014, and 0 otherwise.

The study is tested through the following models:

$$R_{it} = \beta_0 + \beta_1 PCON_{1it} + \beta_2 AQ_{it} + \beta_3 S_{it} + \beta_4 ROA_{it} + \beta_5 MtB_{it} + \beta_6 LEV_{it} + \beta_7 Growth_{it} + \beta_8 Indust_{it} + \beta_9 Crisis_{it} + \beta_{10} REV_{it} + \varepsilon_{it} \quad (1)$$

[4] In contrary to the developed countries or even some emerging countries, there is no body or organization in Egypt provides a database of politically connected firms information. Therefore, all the data contained in this study of politically connected firms were collected and discovered through several sources, such as the organizational structure and ownership structure included in the financial statements as well as social media, and this has also been followed in some prior studies, such as (Faccio, 2010).

$$R_{it} = \beta_0 + \beta_1 PCON_{2it} + \beta_2 AQ_{it} + \beta_3 S_{it} + \beta_4 ROA_{it} + \beta_5 MtB_{it} + \beta_6 LEV_{it} + \beta_7 Growth_{it} + \beta_8 Indust_{it} + \beta_9 Crisis_{it} + \beta_{10} REV_{it} + \varepsilon_{it} \quad (2)$$

$$R_{it} = \beta_0 + \beta_1 PCON_{3it} + \beta_2 AQ_{it} + \beta_3 S_{it} + \beta_4 ROA_{it} + \beta_5 MtB_{it} + \beta_6 LEV_{it} + \beta_7 Growth_{it} + \beta_8 Indust_{it} + \beta_9 Crisis_{it} + \beta_{10} REV_{it} + \varepsilon \quad (3)$$

4/ Discussion of Results:

4/1 Sample Descriptives:

Table (1) shows the distribution of sample firms according to political connection types through major shareholders, top officers, and state ownership. In addition, it clarifies the distribution of sample firms through the audit quality and sectors, respectively.

Table (1): *Characteristics of Sample Firms*

Distribution of the sample firms according to political connections		
$PCON_1$	Number	%
0	57	37.5%
1	95	62.5%
Total	152	100%
$PCON_2$	Number	%
0	36	23.7%
1	116	76.3%
Total	152	100%
$PCON_3$	Number	%
0	86	56.6%
1	66	43.4%
Total	152	100%
Distribution of the sample firms according to audit quality		
AQ	Number	%
0	63	41.4%
1	89	58.6%
Total	152	100%
Distribution of the sample firms according to industry		
Indust	Number	%
Telecommunications	23	15.1%
Basic Resources	10	6.6%
Industrial Goods and Services and Automobiles	20	13.2%
Construction and Materials	13	8.6%
Real Estate	68	44.7%
Food and Beverage	8	5.3%
Personal and Household Products	10	6.6%
Total	152	100%

Descriptive Statistics of Study Variables:

Table (2) shows the descriptive statistics of some study variables; stock returns, firm size, return on assets, Market-to-Book value, leverage and sales growth rate. The descriptive analysis shows values of minimum, maximum, mean and standard deviation. The mean of stock returns is 0.39. The mean of firm size is 8.11 indicating that the firms of sample on average are concentrated in big size. The mean values of return on assets, market-to-book value, and sales growth rate are 2.07, 1.91, and 5.15 respectively. Leverage in the study sample tends to be high as the mean of leverage is 20.17, suggesting that the sample firms depend on long term debts.

Table (2): *Descriptive Statistics*

Variables	Minimum	Maximum	Mean	Std. deviation
R	-2.0000	35.0000	0.3947	2.9458
S	3.0000	11.0000	8.1118	1.7587
ROA	-13.0000	44.0000	2.0658	5.0332
MtB	-3.0000	21.0000	1.9145	2.4330
LEV	0	76.0000	20.1711	18.5364
Growth	-1.0000	472.0000	5.1457	40.1008

Results of the Statistical Analyses:

We perform OLS regression to examine the association between political connections and stock returns. The regression results are presented in Table (3) for the three models.

In the first model, $PCON_1$ has no significant association with stock returns (β= 0.56, t= 0.83, p-value= 0.41). The second model shows that $PCON_2$ has no significant association with stock returns (β = 0.68, t= 0.81, p-value= 0.42). The third model presents that $PCON_3$ has no significant association with stock returns (β = 0.27, t= 0.59, p-value= 0.56).

The results show that market-to-book value is only positively and significantly associated with stock returns in models (1), (2), and (3); where the p-values of market-to-book value are 0.049, 0.045, and 0.048 respectively.

The results are consistent with Abdul Wahab et al. (2007) study, which show no any significant association between stock returns and political connection in Malaysia over a period that encompasses the regulatory change in corporate governance, after establishment of the Malaysian Code on Corporate Governance (MCCG) and it became an integral part of the Bursa Malaysia Listing Rules. In this study, sample firms are classified among EGX30, and are considered the most actively traded (with the strongest performance). Hence, the results may be due to these firms adhering to the requirements of the Stock Exchange and the Egyptian Corporate Governance

Code. However, this assumption is beyond the scope of this study and corroborates further empirical testing.

Table (3): *Regression Results*

Independent variable	B	T	Sig.
Model 1: the relationship between $PCON_1$ and stock returns			
(Constant)	-2.690378	-1.230882	0.2205
$PCON_1$	0.560218	0.829745	0.4081
AQ	0.272882	0.584279	0.5600
SIZE	0.042982	0.219401	0.8267
ROA	0.084643	1.787715	0.0761
MTB	0.832178	1.981553	0.0496
LEV	0.009046	0.626297	0.5322
GROWTH	0.002942	0.991783	0.3231
$INDUST_1$	0.252077	0.257149	0.7975
$INDUST_2$	-0.524777	-0.645219	0.5199
$INDUST_3$	0.381566	0.546899	0.5854
$INDUST_4$	0.271985	0.478191	0.6333
$INDUST_5$	0.627624	1.129073	0.2609
$INDUST_6$	-0.571214	-0.639322	0.5237
Crisis	-0.519212	-1.451424	0.1490
REV	0.187929	0.405005	0.6861
R^2 = 0.523; Adjusted R^2 = 0.469; F-Value = 9.858; Sig. F = 0.000.			
Model 2: the relationship between $PCON_2$ and stock returns			
(Constant)	-3.829678	-1.602266	0.1114
$PCON_2$	0.675627	0.805250	0.4221
AQ	0.268678	0.571265	0.5688
SIZE	0.111170	0.748406	0.4555
ROA	0.092027	1.775663	0.0780
MTB	0.844609	2.020186	0.0453
LEV	0.019346	1.170217	0.2440
GROWTH	0.002416	0.883937	0.3783
$INDUST_1$	0.399126	0.497527	0.6196
$INDUST_2$	-0.437803	-0.462905	0.6442
$INDUST_3$	0.566879	0.625070	0.5330
$INDUST_4$	0.474509	0.746534	0.4566
$INDUST_5$	0.745791	1.285257	0.2009
$INDUST_6$	-0.616258	-0.661361	0.5095
Crisis	-0.516845	-1.418376	0.1584
REV	0.314013	0.671066	0.5033

R^2 = 0.526; Adjusted R^2 = 0.473; F-Value = 9.974; Sig. F = 0.000.			
Model 3: the relationship between $PCON_3$ and stock returns			
(Constant)	-3.132321	-1.476497	0.1421
$PCON_3$	0.270025	0.588038	0.5575
AQ	0.448349	0.792616	0.4294
SIZE	0.124448	0.906785	0.3661
ROA	0.078191	1.747654	0.0828
MTB	0.830866	1.992799	0.0483
LEV	0.019491	1.131245	0.2600
GROWTH	0.002947	0.966411	0.3356
$INDUST_1$	-0.337313	-0.406842	0.6848
$INDUST_2$	-1.059617	-1.123767	0.2631
$INDUST_3$	-0.017158	-0.026566	0.9788
$INDUST_4$	0.308980	0.467265	0.6411
$INDUST_5$	0.460410	0.805597	0.4219
$INDUST_6$	-1.082862	-0.952938	0.3423
Crisis	-0.519274	-1.482677	0.1405
REV	0.168846	0.367430	0.7139
R^2 = 0.521; Adjusted R^2 = 0.468; F-Value = 9.806; Sig. F = 0.000.			

Conclusions:

This study investigates the association between political connections and stock returns of listed firms in the Egyptian stock market, because prior studies show that the political connection is an important determinant of stock returns in stock markets. Based on the different types of politically connected firms, we categorize the political connections in this study into three types.

The results of the statistical analyses suggest no significant association between $PCON_1$, $PCON_2$, $PCON_3$ and the stock returns. The reason may be due to the adherence to stock market requirements; due to the sample firms being in the EGX30 index. Thus, their stock performance may not be as significantly affected by political connections.

As in most social sciences research, this study has some limitations. It tests firms included in EGX30 index. Thus, there are opportunities to conduct future research to investigate the association on a more extended sample and taking into consideration corporate governance practices. Moreover, future research may compare politically connected firms and other non-politically connected firms to determine if they perform better.

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