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## Article

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## FINANCIAL ECONOMICS | LETTER

# Market reactions to financial distress announcements: Do political connections matter?

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**Abstract:** We examined market reactions to the financial distress announcements of listed firms in Malaysia. We investigated whether the market differentiates between the politically connected and non-politically connected vis-a-vis the outcomes at the time of the announcements. There is evidence of differing reactions to announcements by politically connected and non-connected firms. Investors react more negatively to the non-politically connected firms as compared to the politically connected ones. In addition, in the event of emergence from financial distress, the losses of politically connected firms were lower than for the non-politically connected firms.

**Subjects:** Economics; Finance; Business, Management and Accounting

**Keywords:** financial distress; event study; political connections

### 1. Introduction

Corporate political connections nowadays are pervasive around the world and has garnered a great deal of attention to become the topic of interest throughout the world (Faccio, 2006). Generally, politically connected firms have better access to key resources from the government when faced with distressed financial conditions (Faccio, Masulis, & McConell, 2006; Johnson & Mitton, 2003; Tao, Sun, Zhu, & Yang, 2017), lower tax liability (Faccio, 2010), lower risk (Boubakri,

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### PUBLIC INTEREST STATEMENT

Corporate failures have been considered destructive events that captured the attention of the public. Their great relevance is due to the significant economic and social implications associated with them. With regard to the political connections companies, it is expected that these companies commonly received financial support or assistance during times of distressed financial conditions and has high likelihood of success in restructuring their condition. Therefore, it is likely that market participants perceive political connection as beneficial in the event of financial distress even though the announcement of financial distress is considered as bad news. The findings suggest that there were different stock market reactions to the politically and non-politically connected firms. Nevertheless, the market reacts negatively to the financial distress announcement for both politically connected and non-connected companies of which may suggest that investors should not invest in firms that are expected to be in financially distressed condition.

Guedhami, Mishra, & Saffar, 2012) and better access to finance (Fu, Daichi, & Yasuyuki, 2017) of which shows that political connections matter for the firm value. Recent empirical work has investigated political connections' role in enhancing firm value (Boubakri et al., 2012; Faccio, 2010; Faccio et al., 2006; Johnson & Mitton, 2003). Recent studies also find evidence of inverted u-shaped relation between political connections and firm value, suggesting the relation between strength of political connections and the firm value (Chen, Li, Danglun, & Ting, 2017). It indicates that firm value increases initially at a lower level of connections and then begins to decrease at a higher level. If the marginal benefit exceeds the marginal cost, the market will weigh the benefit by increasing the equity value of the politically connected firms (Shleifer & Vishny, 1994). Shleifer and Vishny noted that there are costs for the firm benefits provided by politicians as the latter pursue their political objectives.

There are several motivations for conducting this study. The fact that Malaysia has the world's highest proportion of politically connected companies among public firms has given rise to the present study (Faccio et al., 2006). The inquiry of having the connections by corporate sector in Malaysia is important subject matter as stressed by Johnson and Mitton (2003). Furthermore, Faccio et al. (2006) likewise state in Table III (pg. 2607) that Malaysia is among the nation with highest number of political connected companies. Kang (2002) even labelled Malaysia as crony capitalism where political leaders have tendency of using their power for the benefits of their families and close ties. The Malaysia's capital control policy implemented during the 1998 Asian Financial crisis is regarded as the "relationship-based" capitalism (Rajan and Zingales, 1998). Studies on political connections in Malaysia have centred on examining the impact of capital controls (Johnson & Mitton, 2003), audit fees (Wahab, Zain, James, Haron, & Hutchinson, 2009), analysts' following (How, Verhoeven, & Abdul Wahab, 2014), impact of elections (Fung, Gul, & Radhakrishnan, 2015), capital structure (Fraser et al., 2006) and corporate governance (Bliss, Gul, & Majid, 2011). These studies found that connected firms are inefficient, riskier, weak in sourcing outside funds and subject to government bailouts. The use of Malaysian listed companies as sample may offer some empirical explanation of this issue that have not been highlighted in previous studies. Besides the substantial difference in terms of economic prosperity, the specific institutional framework or environment is fundamentally different across countries, especially between the developed and emerging countries. Previous studies suggest that emerging markets in general have low creditors' rights protection and ineffective law enforcement (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997).

The announcement of financial distress is considered bad news and empirical studies have documented significant negative abnormal returns surrounding the days of the announcements (Beneish & Press, 1995; Lang & Stulz, 1992). The price decline is associated with the investor's prior assessment of the firm's probability of bankruptcy. However, politically connected firms are in a favourable position with the advantage of access to bailouts in the event of financial distress or economic downturn (Faccio et al., 2006). It is expected that these companies commonly received financial support or assistance during times of distressed financial conditions and has high likelihood of success in restructuring their condition. Nonetheless, this has yet to be tested as different investors might react differently and such reaction would also be affected by whether or not the firms are politically connected or otherwise. For this reason, there may be different investor reactions with respect to politically connected firms compared to non-connected firms. Hence, this study set out to explore the impact of political connections following such announcements. Additionally, previous research has not examined the effects of the outcomes (emerged and delisted) on the financially distressed firms that are politically and non-politically connected. Since a company's value is the present value of future cash flows and the market participants have sensible expectations regarding these cash flows by making prior assessments using publicly available information, it is suggested that the market is able to differentiate between the "value" and "less value" companies. This study contributes to the body of literature on this issue by evaluating whether or not the market differentiates the politically connected listed firms in the event of financial distress, which is of considerable interest to both academics and business professionals.

The organization of this study summary has Section 2 outlining the data and method, Section 3 discussing the empirical results and Section 4 concluding the study.

## 2. Methodology

We employed event study methodology by using the market-adjusted returns approach to examine the effect of financial distress announcements on stock prices.<sup>1</sup> The market return data used in this study are taken from the EMAS Index, which provides a better match for financially distressed firms.<sup>2</sup> The first day on which a company is declared distressed (under Practice Note 4/Practice Note 17/ Guidance Note 3 classification) is numbered as event day 0.<sup>3</sup> Data on share prices are collected from the Thomson Reuters Datastream. The total sample consisted of 236 financially distressed firms (excluding finance-related firms) listed on the Bursa Malaysia, starting from 2001 (when Practice Note 4 was introduced) until 2014. A total of 38 politically connected firms, identified through the studies by Faccio (2006), Mitchell and Joseph (2010), Bliss et al. (2011), Chen, Ariff, Hassan, and Mohamad (2013), and Fung et al. (2015) were classified as financially distressed.

## 3. Empirical results

The results in Table 1 suggest that the average abnormal returns (AARs) are negative and statistically significant prior to and after the financial distress announcement for the non-politically connected firms. However, for politically connected firms, the AARs are only significant after the announcement.<sup>4</sup> Interestingly, the results from the AARs show that there were different stock market reactions to the politically and non-politically connected firms. The latter had greater negative stock price effects compared to the connected firms, as shown by the significant AARs of -1.00%, -1.66%, -3.35%,

**Table 1. Daily AARs around the financial distress announcement day**

Event days	AARs (%)		t-statistics	
	Politically connected	Non-politically connected	Politically connected	Non-politically connected
-10	-0.7487	-1.0698	-0.8286	-2.4020**
-9	-0.8217	-0.5152	-1.0220	-1.3560
-8	0.2537	0.0333	0.2456	0.0672
-7	0.4992	0.0506	0.8882	0.0926
-6	-1.3522	-0.2640	-0.9969	-0.3946
-5	-0.8212	-1.6239	-0.7737	-2.9195***
-4	-0.5425	-1.0306	-0.6871	-2.3250**
-3	1.1213	-0.2169	0.6947	-0.3937
-2	-0.7080	-0.9991	-0.8204	-1.9102*
-1	0.0619	-1.6603	0.0537	-1.8974*
0	-0.2631	-3.3520	-0.2904	-3.7506***
1	-16.1135	-18.5559	-4.8401***	-11.9818***
2	-14.0155	-10.8758	-5.2417***	-7.4462***
3	0.4038	-3.1482	0.2899	-2.9822***
4	-4.3884	-2.3985	-3.4621***	-2.3083**
5	-1.4427	-2.6972	-1.0894	-2.8746***
6	-0.8416	-0.0106	-0.8106	-0.0141
7	0.0513	-0.1064	0.0443	-0.1689
8	0.3518	-1.5558	0.4078	-2.7840***
9	0.4659	-0.5021	0.2371	-0.5914
10	-1.2978	-1.2259	-1.2153	-2.0079**

Notes: t-statistics test the null hypothesis that the average abnormal returns are equal to zero. \*, \*\* and \*\*\* indicate statistical significance at the 10%, 5% and 1% levels.

-18.56% and -10.88% for the respective days -2, -1, 0, 1 and 2. The significant AARs for politically connected firms on days 1 and 2 were -16.11% and -14.01%, respectively. Nevertheless, the AAR is not significant on day 0. These findings indicate that investors value a firm's political connections favourably.

The cumulative average abnormal returns (CAARs) in Table 2 indicate that politically connected firms experience lower negative returns than the non-politically connected firms in all windows. For example, during the (-30 to -1), (-1 to +1), (+1 to +30) and (-60 to +60) periods, the CAARs are -5.77%, -16.31%, -36.51% and -43.99%, respectively for politically connected firms and -11.50%, -23.57%, -40.40% and -61.04%, respectively for non-politically connected firms. Moreover, the mean difference of CAARs (-1, +1) between the politically and non-politically connected firms is 7.25% with significance at the 10% level (Table 2). These results show that there are discrepancies in the reaction of investors to financial distress announcements between the politically and non-politically connected firms. Investors react more negatively to the non-politically connected firms as compared to the politically connected firms. It is likely that market participants perceive political connection as beneficial in the event of financial distress even though the announcement of financial distress is considered bad news. Figure 1 shows the difference in the price effect between the two groups.

This study further analysed the differing effects of announcements on financial distress outcomes between the politically and non-politically connected firms. Table 2 also presents the mean difference in CAARs between these firms. Overall, the financially distressed companies that were eventually delisted experienced higher losses than the emerged companies, which suggests that the market anticipates the outcomes of financially distressed conditions.<sup>5</sup> This empirical evidence is in line with the findings of Rose-Green and Dawkins (2000), who reported that firms that were subsequently liquidated experienced a greater negative stock price effect as compared to the reorganized firms surrounding the days of bankruptcy filings announcement. With respect to the firms' political connections, the losses of connected firms were lower in all windows than those of the non-connected firms that emerge from financial distress. In the (-30 to -1) window, politically connected firms lose 6.19% compared to the non-politically connected firms where the losses were 11.67%. This constitutes evidence of investors' belief that political connections can give extra mileage to firms' recoveries. In this sense, the share price response to distress announcement is tied to the political connections of the companies.

Figure 2 plots the CAARs over days -60 to +60 on the outcomes of financial distress between the politically connected and non-connected firms. As shown, investors react more negatively to the non-politically connected firms for both outcomes of financial distress. The findings indicate that the reactions of the stock prices to financial distress announcements are influenced by the political synergy of the firm.

#### 4. Conclusion

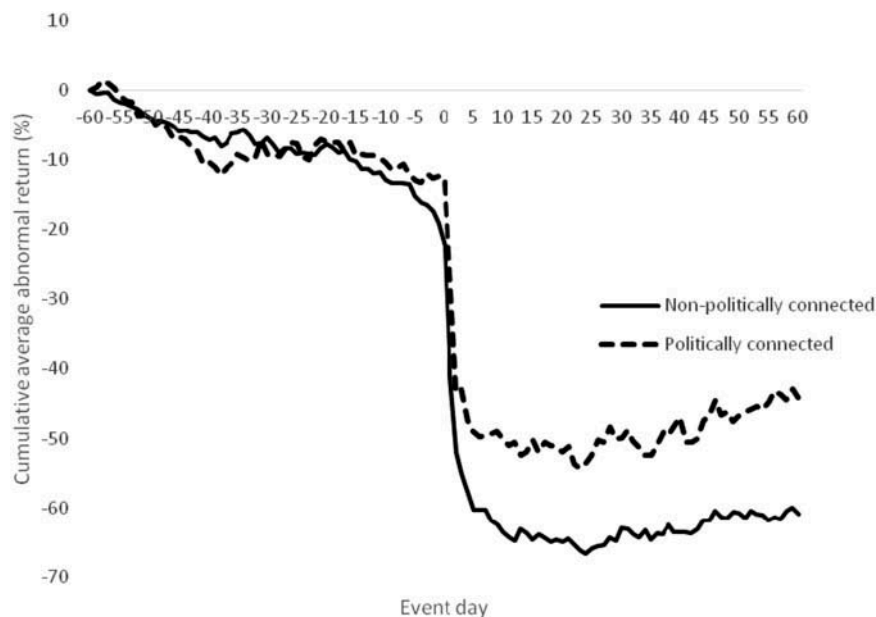
This study examined whether the market differentiates politically connected listed firms in the event of financial distress. The evidence suggested that investors react less negatively to politically connected firms during announcements of financial distress. The evidence was also consistent with regard to the outcomes of financial distress. The findings suggested that, in Malaysia, investors value a firm's political connections favourably of which shows that political connections matter for the firm value (Faccio, 2010; Faccio et al., 2006). Relating the present empirical evidence of the investigated issue on the efficient market hypothesis, it can be suggested that the market is inefficient with regard to the financial distress announcement. The announcements have led to significant negative effect to the affected companies' for most of the event windows. The findings of this study provide important implications for potential investors in understanding the financially distressed listed companies. Investors expect the event of financial distress even before the announcement is made. As expected, the market reacts negatively to the financial distress announcement for both politically connected and non-connected companies as evidenced by the negative abnormal returns. In this sense, investors should not invest in firms that are expected to be in financially distressed condition. Future research might explore the performance of the

**Table 2. CAARs surrounding the announcement day by outcomes**

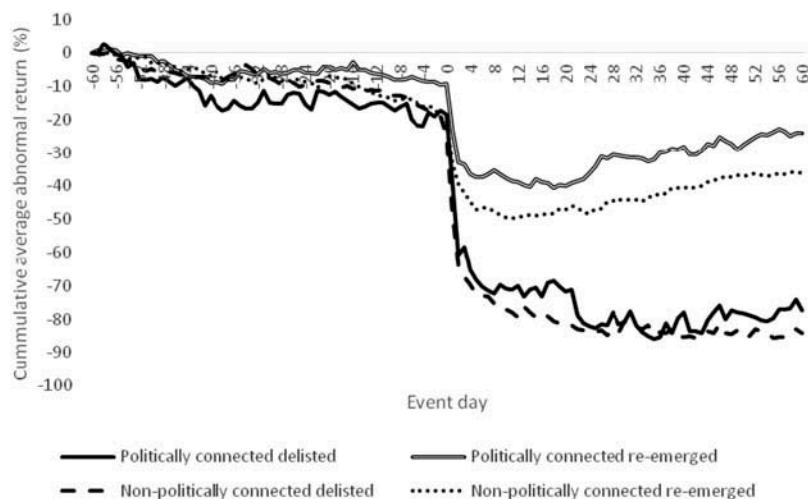
Sub-sample	(-30, -1)		(-1, +1)		(+1, +30)		(-60, +60)	
	CAARs (%)	t-statistics	CAARs (%)	t-statistics	CAARs (%)	t-statistics	CAARs (%)	t-statistics
Politically connected (n = 38)	-5.77	-1.5673	-16.31	-4.0720***	-36.51	-5.8917***	-43.99	-4.2279***
Non-politically connected (n = 198)	-11.50	-5.6849***	-23.57	-13.2285***	-40.40	-13.7657***	-61.04	-13.5380***
Difference <sup>a</sup>	5.73	1.364	7.25	1.654*	3.88	0.567	17.05	1.504
<b>Outcomes</b>								
<b>Re-emerged</b>								
Politically connected (n = 25)	-6.19	-1.8649*	-14.06	-3.8247***	-21.69	-3.1781***	-25.33	-3.0615***
Non-politically connected (n = 96)	-11.67	-5.3798***	-16.64	-7.4048***	-23.79	-6.4974***	-35.16	-6.4589***
Difference <sup>a</sup>	5.48	1.382	2.59	0.601	2.10	0.271	9.83	0.992
<b>Delisted</b>								
Politically connected (n = 13)	-4.97	-0.5562	-20.66	-2.1734**	-65.01	-8.1220***	-79.87	-3.4079***
Non-politically connected (n = 102)	-11.34	-3.3698***	-30.08	-11.6416***	-56.02	-14.1172***	-85.40	-13.7412***
Difference <sup>a</sup>	6.37	0.668	9.43	0.957	-8.99	-1.006	5.53	0.228

Notes: t-statistics test the null hypothesis that the cumulative average abnormal returns are equal to zero. \*, \*\* and \*\*\* denote statistical significance at the 10%, 5% and 1% levels, respectively. <sup>a</sup>To compare the mean difference, t-statistics under the assumption of unequal variances and two-tailed test were utilized.

**Figure 1. CAARs surrounding the announcement day.**



**Figure 2. CAARs surrounding the announcement day of financial distress outcomes (delisted and re-emerged) on politically connected versus non-politically connected firms.**



connected firms after their emergence from financial distress condition. The long-run share price performance or operating performance of the emerged politically connected companies after the restructuring period may enrich the current empirical results.

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**Notes**

1. This study did not use the market model approach due to the instability of beta for financially distressed firms. In line with Dawkins, Bhattacharya, and Rose-Green (2007) and Hubbard and Stephenson (1997), it was difficult to identify a non-event estimation period for bankrupt firms. In addition, McEnally and Todd (1993)



- posited that beta is unreliable for bankrupt firms since beta decreases prior to bankruptcy.
- EMAS Index is employed following the study by Dawkins et al. (2007) who utilized CRSP equally weighted return as the market index. They find that bankrupt firms' sample is smaller than the median CRSP firm. In addition, market capitalization of the financially distressed companies is moving on a downward trend. Therefore, it could be argued that the KLCI Index may not be the suitable benchmark and may lead to downward-biased estimation results. Nevertheless, the estimation using the KLCI Index was carried out and suggested similar results. The results were not reported due to space considerations but are available upon request.
  - Bursa Malaysia's website provides the announcement dates of the financially distressed companies.
  - AARs were calculated over the -60 to +60 interval relative to the event day  $t = 0$ . Due to space constraints, only AARs for the -10 to +10 interval are reported.
  - In unreported results, the mean difference of CAARs between the delisted and emerged companies sub-groups is 12.91%, 33.68% and 51.64% for the (-1 to +1), (+1 to +30) and (-60 to +60) periods, respectively, with significance at the 1% level.
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