

An Empirical Study of Equity Incentive on the Stock Valuation of Tobacco Companies

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Objectives: Since the China Securities Regulatory Commission (CSRC) issued the Measures for the Administration of Equity Incentives of Listed Companies, the equity incentives of A-share listed companies have become normalized, the discussion of the effect of the implementation of equity incentives on stock valuation can provide a reference for investors whether to choose listed companies with equity incentives for stock valuation. This paper uses python tool to select 30 A-share listed companies that formally started to implement equity incentives in 2018 and the proportion of equity incentives is between 4% and 6% as the sample, and uses cross-sectional data model for empirical analysis. The empirical results show that: first, the implementation of equity incentive in Chinese listed companies has a positive impact on stock valuation, and the impact of equity incentive on stock valuation is significantly better than that before implementation, and the incentive stocks have more investment value; Second, the conclusion is also suitable for Chinese tobacco related companies, which has important reference value for tobacco preference investors.

Key words: equity incentives; stock valuation; tobacco companies; tobacco control
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INTRODUCTION

Since the China Securities Regulatory Commission (CSRC) issued the Measures for the Administration of Equity Incentives of Listed Companies, the equity incentives of A-share listed companies have become normalized, and the equity incentives have become an effective means for listed companies to improve corporate governance and enhance their governance ability. There are many factors that affect the movement of stock price, such as the company's profitability operating ability and information disclosure. For most investors, the financial reports disclosed by listed

companies to the public are an important way for investors to analyze their profitability and future growth. In order to achieve higher returns, investors need to study listed companies, analyze various information and screen out valuable financial indicators to avoid blind investments, so it is increasingly important to make a reasonable evaluation of stocks. The development of equity incentives in China is a process of continuous improvement, and the introduction of the Measures for the Administration of Equity Incentives of Listed Companies in 2016 strengthened the management of listed companies implementing equity incentives, making equity incentives more

adaptable to the market development and influence the performance of the stock in the market. At present, researchers have conducted more systematic and in-depth studies on the issues of equity incentives and stock valuation respectively, forming a relatively sound theoretical system. However, empirical studies combining the two, especially on the effects of equity incentives on stock valuation after the implementation of equity incentives and not implementing equity incentives on stock valuation are less common.

This paper analyzes whether the implementation of equity incentives affects stock valuation, and empirically investigates whether there is a significant differential effect of the implementation of equity incentives on stock valuation of listed companies in China, providing a new perspective for stock valuation research. In terms of empirical analysis, using statistical test and multiple linear regression analysis, the comparison between before and after the implementation of the equity incentives concludes that the implementation of equity incentives has a significant positive effect on stock valuation, and the effect of the implementation of equity incentives on stock valuation is significantly better than that before the implementation.

Compared with ordinary consumer goods, tobacco and tobacco products have their particularity, which not only plays an important role in the economic development of all countries in the world, but also plays a different role in people's daily life.

In China, the production and sales of tobacco leaves, cigarettes and other tobacco products and related tobacco machinery, raw and auxiliary materials have an important impact on fiscal revenue. In 2020, China's tobacco industry achieved a total industrial and commercial tax profit of 1280.3 billion yuan, a year-on-year increase of 6.2%, and a total fiscal revenue of 1203.7 billion yuan, an increase of 2.3%. The total tax profit and fiscal revenue reached a record high, making a positive contribution to the increase of national and local fiscal revenue and economic development.

Using the above conclusion to invest in Chinese listed tobacco related companies, it is found that the conclusion is also suitable for Chinese tobacco

related enterprises, which has important reference value for investors who prefer tobacco.

LITERATURE REVIEW

Due to the early development of stock markets in Western countries, it is more common for companies to use equity incentives. As early as 1976, Jensen and Meckling conducted a study on the importance of equity incentives and their relationship with company performance, where they argued that the interests of shareholders and management would be aligned by equity incentives, thus improving the performance of listed companies¹. Mehran conducted an empirical analysis with a research sample of 153 United States manufacturing companies and concluded that the higher the shareholding of the management of a listed company, the more profitable the company is, and they have a positive correlation, which reflects the importance of equity incentives for the company². Fabrizi showed that banks with high chief executive officer (CEO) equity incentives perform significantly worse than banks with low CEO equity incentives. The incentive to boost stock prices motivates CEOs to take costly risks and they prefer to securitize riskier loans³. Ali et al. found that CEOs use equity-linked compensation to gain more personal benefits. Equity incentives can increase the surplus level of a firm⁴. Benson and James also proposed a significant but heterogeneous correlation between CEO equity incentives and firm value, CEOs differentially enhance firm stock prices by expanding investment opportunities and increasing risk tolerance⁵. By studying the motivation of listed companies to implement equity incentives, Chen and Zhou pointed that the performance of listed companies with equity incentives for senior management is significantly higher than that of listed companies without equity incentives⁶. Li and Huang conducted a regression analysis on a sample of Chinese listed companies that implemented employee stock ownership between 2006 and 2012, and the results showed that the growth of corporate performance after the implementation of equity incentives is significant⁷. Yan and Li used financial data to study the relationship between executive equity incentives and operating efficiency of Chinese

listed companies from 2007 to 2015, and concluded that the implementation of equity incentives for executives can improve the operating efficiency of companies, thus promoting the improvement of corporate performance⁸. Tian and Qi conducted an empirical analysis with 245 listed companies that implemented equity incentives from 2012 to 2016, and concluded that there is a positive relationship between equity incentives of listed companies and company performance, and the greater the percentage of equity incentives, the better the company's performance⁹. Cui also found a positive relationship between equity incentives and company performance of listed companies¹⁰. Besides, Tong and Yang (2019) established a model for empirical analysis with a research sample of listed companies that started to implement equity incentives in 2012, and the empirical results showed that the implementation of equity incentives for senior employees would improve the performance of listed companies¹¹. By studying the relationship between equity incentives and company performance of listed companies, Kong and Yang (2019) concluded that a higher percentage of equity incentives is more beneficial to improve the performance of manufacturing companies¹². Song and Li used a model to empirically analyze 251 listed companies that announced and implemented equity incentives plans between 2007 and 2013, and concluded that the implementation of equity incentives can improve the profitability of listed companies¹³. Yang conducted an empirical analysis with listed companies that started to implement equity incentives in 2016, and the results showed that the percentage of executive shareholding has a positive effect on return on assets¹⁴. Similarly, Lin and Liu selected a sample of 111 companies in the software and information technology services industry from 2006 to 2014 and found that for the short term, the effect of equity incentives is manifested in the ability to increase the stock price in the capital market, and in the long term, the effect is manifested in a significant increase in returns on net assets and total assets¹⁵.

As mentioned above, the significant correlation between equity incentives and profitability of listed companies is recognized by most researchers at home and abroad. The implementation of equity incentives

is essentially a long-term incentive system for business owners to operators. It usually refers to the process of granting a certain percentage of shares or options to the management and outstanding employees of a listed company to entitle them to shareholder rights, thus motivating them to participate in the operation and decision-making of the company. The correct implementation of equity incentives is important for enterprises to attract and retain core talents, motivate performance improvement, restrain short-term behavior of employees, improve internal management, motivate upstream and downstream suppliers, and promote long-term development. Most of the studies by domestic and foreign scholars focus on the relationship between equity incentives and company performance, and the research on equity incentives and stock valuation is relatively rare. However, the research on the effect of equity incentives on stock valuation can draw on the relationship between equity incentives and operating performance, and it can be analyzed by the effect of equity incentives on financial indicators of listed companies.

THEORETICAL ANALYSIS AND RESEARCH HYPOTHESIS

Modigliani and Miller, Nobel laureates in economics, argued that it is the profitability of assets that is the determining factor in the stock price of a company. Through empirical study, Feltham and Ohlson proved that there is a linear relationship between the intrinsic value of a company's stock and the residual income and book value of the stock. Zhao concluded that the intrinsic value of the stock is determined by the return on net assets and the growth rate of net assets through the study of the internal net ratio decision model¹⁶.

Stock price is closely related to the intrinsic value of the company. There are two common ways for stock valuation, one is the direct valuation method that directly values the stock based on relevant indicators of the stock such as cash flow valuation, economic value added (EVA) valuation, etc. The second is the relative valuation method based on the return on net assets, market value or replacement cost, price-to-earnings ratio and price-to-net ratio of the stock, etc.

Return on net assets and the stock value of the company are positively related, but the returns on net assets are different for listed companies in different cycles and industries, so they cannot be compared. The method of stock valuation in terms of net assets has certain limitations. In contrast, return on total assets is a comprehensive indicator that not only reflects the profitability and operating ability of the company's assets, but also analyzes the stability and durability of the company's earnings. Therefore, this paper selects the return on total assets related to net assets as the method of stock valuation. To a certain extent, a higher return on total assets indicates a better overall utilization efficiency of the listed company, which means a higher stock value of the listed company. On the contrary, the lower the return on total assets is, the lower the stock value of the listed company is. Based on the above theoretical analysis, the hypothesis is proposed.

H1: The equity incentives ratio has a positive effect on the return on total assets, that is, the implementation of equity incentives increases the stock valuation.

The equity incentives ratio reflects the percentage of shares held by the management and outstanding employees of the listed company, and is closely related to the operation and investment value of the listed company and the stock valuation by investors. Accordingly, the hypothesis is proposed.

H2: The stock valuation of listed companies with equity incentives will be better than that of listed companies without equity incentives.

The equity incentives ratio reflects the percentage of shares held by the management and outstanding employees of the listed company, and is closely related to the operation and investment value of the listed company and the stock valuation by investors.

EMPIRICAL ANALYSIS

Sample Selection

Firstly, this article constructs a multiple linear regression model through data collection, sample selection and variables selection to empirically investigate the effect of having and not having equity incentives on stock valuation of listed companies. Secondly, through python tools, the

investment value of stocks with high equity incentives is empirically analyzed by using quantitative software for stock selection.

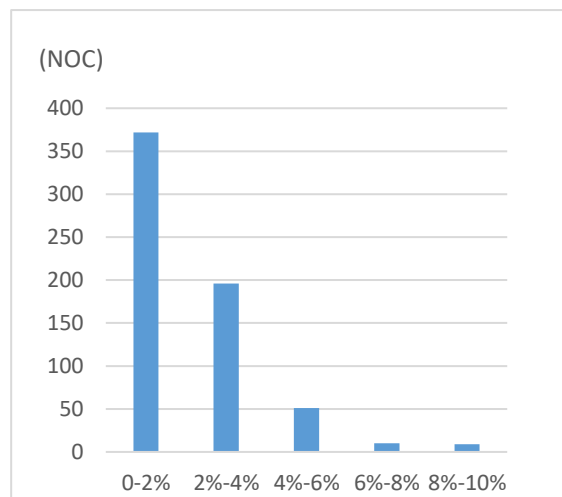


Figure 1 Distribution of the Equity Incentives Ratio of 638 Listed Companies in 2018

From the above chart, it can be seen that the equity incentives ratio of Chinese listed companies is mostly concentrated between 0 and 6%, and the equity incentives ratio is too low to have a good incentive effect, so the listed companies with too low equity incentives ratio are excluded. Thus, the data of 30 listed companies in Shanghai and Shenzhen A-shares that formally started to implement equity incentives in 2018 and the equity incentives ratio is between 4% and 6% are selected as samples for the study. For the listed companies without equity incentives, the above 30 listed companies before the implementation of equity incentives are used as the sample. There are 22 listed companies related to tobacco in China. Excluding the missing data, there are 19 active tobacco companies since 2019, including 10 equity incentive companies¹⁷. The information of listed companies' codes and names are mainly obtained from the annual reports of equity incentives and the website of CNIOFO. The financial indicators such as the equity incentives ratio, profitability, operating condition, and stock issuance and circulation status are obtained from Royal Flush software and China Stock Market & Accounting Research (CSMAR) Database.

Variables Selection

This paper focuses on the effect of equity

incentives on the stock valuation of listed companies, so the stock valuation indicator is used as the explained variable in the empirical study. And through the previous theoretical analysis, the return on total assets and equity incentives ratio are selected as core explanatory variables.

There are many factors influencing stock valuation, and the profitability, operation and future growth will also affect the research results. Using equity incentives alone as explanatory variable will lead to bias in the empirical results. To improve the reliability of the empirical results, three indicators, namely, earnings per share, net assets per share and net sales margin, are selected as control variables in this paper.

Among them, earnings per share is an important indicator of the company's operating results, risk profile and the common stock profitability. The larger the ratio, the greater the profit per share, and conversely, the smaller the ratio, the smaller the

profit per share. Net assets per share is an important indicator of the present value of assets per share. The larger this indicator, the higher the value and profitability, the higher the value of assets per share owned by shareholders, and the higher the growth of the company. Net sales margin is often used to measure the profitability of a company over a certain period of time. Generally, the larger the indicator, the better the profitability of the company's sales.

Earnings per share, net assets per share, and net sales margin are commonly used to measure a company's operating capacity, profitability, and to predict its future growth, and are important indicators for investors to make judgments and decisions. Therefore, these variables are designed as control variables.

The choice of variables with and without equity incentives is specified as follows table 1

Table 1 Definition of Variables				
Variable type	Variable classification	Variable name	Variable label	Variable meaning
Explained variable	Return on total assets	Return on total assets	ROA	Net assets / Average total assets
Explanatory variable	Equity incentives ratio	Share incentive ratio	MSR	Number of equity incentives / Total share capital
Control variable	Operating conditions	Earnings per share	EPS	Profit after tax / Total share capital
		Net asset value per share	BVEPS	Shareholders' equity / Share capital
	Profitability indicators	Net sales margin	TTM	Net profit / Sales revenue

Model Specification

Model with equity incentives

By analyzing the above variables, the model with return on total assets as the explanatory variable, equity incentives ratio as the explanatory variable, and earnings per share, net assets per share, and net sales margin as the control variables is set up as follows:

ROA=

$\lambda_0 + \lambda_1 MSR + \lambda_2 EPS + \lambda_3 BVEPS + \lambda_4 TTM + \mu_t$

λ_0 : is the equation intercept term.

λ_i : is the regression coefficient.

μ_t : denotes the random error term, which indicates the factors other than the above.

Model without equity incentives

Under the exclusion of the equity incentives ratio, the model with return on total assets as the explanatory variable, and earnings per share, net

assets per share, and net sales margin as the explanatory variables is set up as follows:

$$ROA = \lambda_1 + \lambda_2 EPS + \lambda_3 BVEPS + \lambda_4 TTM + \mu_t$$

λ_1 : is the equation intercept term.

λ_i : is the regression coefficient.

μ_t : denotes the random error term, which indicates the factors other than the above.

ANALYSIS OF EMPIRICAL RESULTS

Correlation Test Analysis

Multicollinearity test

In order to avoid affecting the regression analysis results due to the potential multicollinearity between the explanatory and control variables, this

paper performs the relevant multicollinearity tests for the explanatory and control variables that selected for the two models with and without equity incentives, respectively. And the variance inflation factor (VIF) method is used to conduct the test. The results are shown in Table 2.

From Table 2, it can be seen that the decidable coefficients R^2 of the auxiliary regressions of the two models are low, and the VIF_j of X1, X2, X3, X4 in the model with equity incentives and X2, X3, X4 in the model without equity incentives are much smaller than the judgment criterion 10, which indicates that there is no multicollinearity problem in both models, so there is no need to correct the model

Table 2 Auxiliary Regression R2 value

Model with equity incentives			Model without equity incentives		
Explanatory variable	R2	VIF _j =1/1-R2 _j	Explained variable	R2	VIF _j =1/1-R2 _j
X1	0.127850	1.14659	X2	0.452608	1.8268
X2	0.610074	2.5645	X3	0.410445	1.6961
X3	0.531774	2.1357	X4	0.156016	1.1848
X4	0.284103	1.3968			

Heteroskedasticity test

At the 0.05 confidence level, we can get $nR^2 = 12.86020 < \chi^2_{0.1}(14) = 23.6848$ from the regression results of the model with equity incentives, so the model does not have heteroskedasticity. From the regression results of the model without equity incentives, we can get $nR^2 = 10.32037 < \chi^2_{0.1}(9) = 16.919$, so the model does not have heteroskedasticity.

Autocorrelation test

At the 0.05 confidence level, we can get $DW = 1.692627$ from the regression results of the model with equity incentives, where $n=30$, $k=4$, and according to the d-statistic scale, we can get that $dL=1.143$, $dU=1.739$, $du < DW < 4 - du$, means there is no autocorrelation in the model. From the regression results of the model without equity incentives, we can get $DW = 2.734159$, where $n=30$, $k=3$, and according to the d-statistic scale, we can get: $dL=1.214$, $dU=1.650$, $4 - du < DW < 4$,

indicating that there is a negative correlation in the model without equity incentives. We correct for the autocorrelation that exists in this model, and there is no autocorrelation in the model without equity incentives after correction.

Regression Analysis

Based on the results of the above model selection, two regression results are obtained as follows.

The first one is the regression results of the implementation of equity incentives.

The second is the modified regression results without equity incentives.

The regression results show that, in the model with equity incentives, equity incentives ratio, earnings per share, net assets per share, and net sales margin have significant effects on the explained variable return on total assets alone or jointly. And in the model without equity incentives, earnings per share, net assets per share, and net sales margin

have significant effects on the explained variable return on total assets alone or jointly. Both can explain most of the variance for the explained variable return on total assets.

Comparative Analysis of the Effects of Implementing and not Implementing Equity Incentives on Stock Valuation

The comparison of the model regression results shows that the model with equity incentives has a significantly greater effect on stock valuation.

At the 0.1 confidence level, the coefficient of equity incentives ratio is 0.97374, which indicates that the equity incentives ratio has a significant positive effect on the return on total assets of listed companies, that is, an increase of 1 percentage in the equity incentives ratio will results in a 0.97374 percent increase in the return on total assets, which is consistent with the hypothesis that the equity incentives ratio is positively related to stock valuation in this paper. The P values of earnings per share, net assets per share and net sales margin are less than 0.1, which means that these three variables have significant effects on stock valuation, although the degrees of the effects are somewhat different. The coefficients of earnings per share and net sales margin in the model with equity incentives are respectively 11.25075 and 0.124302, and the

coefficients in the model without equity incentives are respectively 10.24617 and 0.199259, which means that the effect of implementing equity incentives is greater than that of not implementing equity incentives. While the λ coefficients of net assets per share in the two models are -0.963507 and -1.042488, respectively, the negative effect of net assets per share on total assets return in the model with equity incentives is relatively small.

Backtesting Analysis of the Stock with Equity Incentives

This paper uses python as a tool to test the performance of the stock with equity incentives in the stock market after the novel coronavirus outbreak through the algorithmic trading platform QuantConnect. The backtesting condition is set with an initial capital of RMB 1 million for the period from February 3, 2020 to June 30, 2020. The 30 stocks are bought at market price with equal weight, and with a commission of one thousandth of the price close to the firm offer.

The backtesting results show that stocks with equity incentives have better investment returns in a situation where the effect of the novel coronavirus epidemic on the real economy and corporate production earnings is temporarily more difficult to measure, and the results See Table 3 below:

Table 3 Returns of the strategies (Back Test Time: February 3, 2020 - June 30, 2020, Currency Unit: Yuan)					
Opening Fund	10 million	Total assets	11172790.90	Benchmark yield	9.99%
Transaction proportion	100%	Accumulated profit and loss	1172790.90	Annualized rate of return	42.61%
Expense ratio	1%	Accumulated service charge	34487.23	Maximum pullback	13.65%
Sliding point ration	0.01%	Cumulative rate of return	17.28%	Winning rate	63.91%

During the back test, a total of 1,474 positions were opened and 1,352 positions were closed. The final winning rate reaches 63.91%. Stocks with equity incentives significantly outperform the broader market.

Analysis of Stock Investment Value of Tobacco Listed Companies

From January 1, 2019 to September 10, 2021, the shares of listed companies of tobacco enterprises

significantly outperformed the market. The cumulative income of listed companies of tobacco enterprises reached 1607.8%, and the Shanghai and Shenzhen index rose 68.83% in the same period. The cumulative income of listed companies of tobacco was 23.36 times that of the Shanghai and Shenzhen 300 index. The investment value of listed companies of tobacco enterprises was very significant.

On January 20, 2020, since the outbreak of the epidemic, the cumulative stock income of listed companies of tobacco enterprises has reached 612.19%, and the Shanghai and Shenzhen index has increased by 19.77% in the same period. The cumulative income of listed companies of tobacco is 30.97 times that of the Shanghai and Shenzhen 300 index. Under the background of the epidemic, listed companies of tobacco enterprises have more investment value.

Comparative Analysis of the Impact of Equity Incentive on the Stock of Tobacco Listed Companies

From January 1, 2019 to September 10, 2021, the shares of listed companies with equity incentives significantly outperformed the market. The cumulative return of listed companies with equity incentives reached 1361.37%, and the Shanghai and Shenzhen index rose 68.83% in the same period. The cumulative return of listed companies with equity incentives was 19.78 times that of the Shanghai and Shenzhen 300 index in the same period. Although the listed companies of tobacco enterprises with equity incentive significantly outperform the market, they have little advantage over other tobacco companies.

On January 20, 2020, since the outbreak of the epidemic, the stock cumulative income of listed companies of equity incentive tobacco enterprises has reached 444.57%, and the Shanghai and Shenzhen index has increased by 19.77% in the same period. The cumulative income of listed companies of equity incentive tobacco enterprises is 22.49 times that of the Shanghai and Shenzhen 300 index in the same period. Under the background of the epidemic, listed companies of equity incentive tobacco enterprises also have more

investment value, but it has little advantage over other tobacco companies.

CONCLUSIONS AND RECOMMENDATIONS

Conclusions

Firstly, the regression analysis of the model with equity incentives shows that there is a significant positive relationship between the equity incentives ratio and the return on total assets, that is the increase in the equity incentives ratio will result in an increase in the return on total assets. Therefore, it is concluded that the implementation of equity incentives can bring certain excess return to the company in the short term, drive the stock price up, and increase the stock valuation level.

Secondly, by comparing the statistical values and regressions of the two models with and without equity incentives, it can be concluded that the effects of implementing and not implementing equity incentives on the return on total assets of listed companies are different, but the effect of implementing equity incentives on the return on total assets is largely better than that of not implementing equity incentives. That is, the effect of implementing equity incentives on stock valuation is greater than that of not implementing equity incentives. In the case that the pneumonia epidemic caused by the novel coronavirus will have a greater negative impact on the short-term economy, stocks with equity incentives are more valuable for investment.

Finally, compared with other companies, tobacco listed companies and stock listed companies have more investment value, but the performance of tobacco listed companies with equity incentive is not significant in similar companies¹⁸.

Recommendations

In this paper, it can be concluded that there is a positive relationship between the implementation of equity incentives and stock valuation. Therefore, this paper makes the following recommendations: Firstly, listed companies should establish a sound supervision system and continuously strengthen the supervision of the management and shareholders to provide good conditions for the implementation of equity incentives. Secondly, listed companies

should adopt reasonable incentive mechanism according to the characteristics of the company to motivate the management and excellent employees to make continuous improvement, work hard, improve the level of corporate governance and enhance the competitiveness of the company to attract more investors. Thirdly, with the gradual improvement of the conditions for the implementation of equity incentives in China, more and more investors notice the investment value of listed companies with equity incentives. However, since the current securities market in China is not very sound, there is a phenomenon of investors blindly following the trend. For investors, they should choose the listed companies that implement equity incentives for stock valuation based on their own actual situations. Third, there are now more than 300 million smokers in China. If the tobacco control account is carefully calculated, smoking brings various hidden dangers and costs to society, environment and health. The annual hidden cost consumes more than 350 billion yuan, and the investment value of tobacco enterprises will be affected in the future.

Author Declaration

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