Shareholding structure and corporate risk

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Ownership structure: the data

- In Europe:
  - 34% of listed Western European firms have more than one large owner (i.e. more than a 10%) (Laeven and Levine 2008)
  - the median size of the second-largest voting block in publicly listed companies exceeds 5%;

- In U.S. :
  - 20% have only one shareholder with a stake larger than 5%, i.e. blockholder;
  - 67% of public firms have more than one blockholder;
  - 13% are widely held

- All over the world:
  - 25% of the firms in various countries have at least two blockholders (La Port at al 1999)

Why more than 1 Blockholder?

- What is the role of mid size blockholders?
- How can they influence firm's decisions?
- Which is their effect on share price?
- Should we favor multiple blockholders?
- Which regulation should we put in place?

Our model

- We argue that mid-sized blockholders exercise their influence by becoming pivotal in shareholder voting decisions.

- Mid-sized blockholders serve to mitigate the conflicts of interest between the largest blockholder and dispersed shareholders.

- This limits expropriation of small shareholders.

Why 1 blockholder?

- In a world with perfect capital markets investors would like to hold a perfectly diversified portfolio.
- Hence no large block should arise.

- Value destroying reasons :
  - Expropriation of smaller shareholders.

    This allows a large blockholder to seize a fraction of cash flows larger than the fraction of shares held.

Why 1 blockholder?

- Value enhancing reasons

Active monitoring (Shleifer and Vishny, 1986)

Consider a firm held entirely by small shareholders. No shareholder has an incentive to monitor the manager.

If a shareholder holds a large enough fraction of shares, he has the incentive to monitor: the gain from monitoring exceeds the costs.

The disadvantage of having a large block are:

- Lack of diversification;
- Illiquidity;
- Opportunity costs.

Why 1 blockholder?

- Value enhancing reasons

"Monitoring with the feet" (Admati and Pfeiderer 2009, Edmans 2009):

Manager's compensation typically depends on share price and investors have short sales constraints.

$\Rightarrow$ Negative information not reflected in share price.

Blockholder can threaten to exit by selling shares. Provides the manager with incentives to exert effort.

Why 1 Blockholder?

- Value enhancing reasons

Alignment of interest (Prendergast 2002):

When the manager has a large fraction of shares in the firm his/her interests are aligned with the shareholders. So he exerts effort to maximize firm value.

Why more than 1 blockholder?

- Capital constraints (Zwiebel 1995).

  Blockholder arise to extract some benefit or expropriate small shareholders.

  Multiple blockholders arise because of capital constraints.

  – Leaves open the question why capital cannot be provided by dispersed shareholders.

- Commitment device to reduce cash diversion.

  A large blockholders can divert cash. The presence of multiple blockholder reduce the incentive of cash diversion (Bennedson and Wolfenzon, 2000).

Voting

- We look at the role of voting in a firm.
  - While shareholders have other means to exercise their control over management, the voting power is a good proxy of their influence.
  - There is an increased awareness of the importance of voting as a tool to affect firm's decisions by institutional investors.
  - For example, the emergence of service providers such as the ISS (Institutional Shareholder Services) or ProxyInvest is an indication of the importance given by investors to vote.

Absenteeism

- Absenteeism and abstention is a prevalent concern in voting.
  - In the US voter turnout of shareholders is between 70% and 80%.
  - GMI Ratings for CalPERS (2013) documents the importance of absenteeism.
  - The AMF in 2012 supports vote participation and recommend firms to facilitate vote participation.

The model

- There is one shareholder (initial owner) who owns a large fraction of shares to have monitoring incentive.
- Initial owner raises equity capital for investment.
- All shareholders are risk averse.
- Firm has to take a decision on risk/return of investment.
- Assume that higher expected returns can be achieved when a more risky investment strategy is chosen.
- Decision is taken through shareholder vote.
- Suppose that some small shareholders do not vote.

Mechanism

- The large shareholder has a greater risk exposure (less well diversified) and therefore he prefers lower risk/ return projects compared to small shareholders.

- Shareholder absenteeism creates a wedge between cash flow rights and voting rights:

  Large shareholders effectively have more voting rights than cash flow rights.

- So even if the large shareholder holds less than 50% of the cash flow rights, he/she might have the majority of votes cast.

The role of mid-sized blockholder

- A mid-sized shareholder can arise and shift the vote towards the small investors' preferred risk/return point.

- Paradoxically, acquiring a larger stake, his/her preferences move closer to the large shareholder.

- The large shareholder benefits from the rise of a mid-sized blockholder: it is a commitment device to choose high risk/return projects.

- This increases firm value and allows the large shareholder to sell the shares at a higher price.

The role of mid-sized blockholders

- Small shareholders benefit from the rise of the mid-sized blockholder because the higher risk/return choice is implemented but they do not bear the costs in terms of poor diversification.

- In this sense the mid-sized blockholders provide a public good.

- In Europe, where large stakes by families are prevalent, additional blockholders can serve to encourage entrepreneurship and risk taking.

Risk and Ownership structure: Empirical implications

- The larger the number of blockholders the higher is firm value (Lehmann and Weigand 2000, Volpin 2002 and Maury and Pajuste 2005)

- The larger the participation of the large blockholder the smaller the risk (Faccio et al 2001 John et al 2008, Laeven and Levine 2008)

- The larger the number of blockholders the larger the risk of the firm's investments.

Regulation and ownership structure

- Economic systems that thwart voting by minority shareholders should have firms with ownership that is more concentrated.

- There is indirect evidence from the comparison of ownership structures in the UK and the US (Becht et al 2009).
  - UK is characterized by firms with higher risk taking and higher value creation than the US.
  - This is due to UK pension fund activism. The UK legal system favors smaller but significant ownership stakes that can be thought of as mid-sized blocks.

Ownership structure and IPO underpricing

- According to our theory, IPO underpricing arises when mid-sized blocks are present.

- When mid-sized blockholders are present share prices are below the reservation price of small shareholders.

- This is consistent with some empirical studies that find a relationship between underpricing and ownership structure (Brennan and Franks, 1997, Fernando et al. 2003, and Goergen and Renneboog, 2002).

Other empirical implications

- Firms operating in very risky sectors can potentially suffer large conflicts of interest between the largest blockholder and small shareholders.

- Our model predicts multiple-blockholder ownership structures in such firms, whereas firms operating in sectors that are more mature should tend to have only one large shareholder with a fringe of small shareholders.

- Firms with significant growth opportunities should exhibit larger conflicts of interest among shareholders. Hence, we expect such firms to have less-dispersed ownership structures.

Conclusions

- We argue that voter absenteeism allows a large blockholder to expropriate small shareholders via the implementation of low-risk / low return projects.
- Mid-sized blocks force decisions to be more aligned with small shareholders
- The large blockholder actually benefits because this effect is priced at the time of issuing shares.