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How much value can blockholders tunnel? Evidence from the Bulgarian mass privatization auctions☆

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Abstract

This study examines the emergence of the Bulgarian stock market and the role of controlling blockholders. A new approach using mass privatization auction data measures the premium for control and demonstrates that, in the absence of legal constraints, majority owners extract more than 85% of firm value as private benefits of control. Institutional investors form portfolios of predominantly controlling positions or participate in majority coalitions. Ownership stakes cluster at 51%. After the privatized companies begin trading on the Bulgarian Stock Exchange, majority-owned firms trade at 40–60% discounts. Overall, the results support the Fama and Jensen (J. law Ecorg 26 (1983) 301) view that majority-owned

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firms cannot persist as publicly traded corporations if the expropriating activities of controlling blockholders are not legally restricted.

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1. Introduction

A majority shareholder can have two very different effects on firm value and minority shareholder wealth. The first effect arises because, compared to small shareholders, a majority shareholder has stronger incentives and more opportunities to monitor management and improve firm performance. The monitoring activities of the large shareholder can lower agency costs in the firm and increase cash flows for all shareholders. Shleifer and Vishny (1986) were among the first to discuss the role of the large shareholder as a monitor who creates shared benefits for all equityholders. This favorable view of blockholders is further developed by Grossman and Hart (1988) and Harris and Raviv (1988), among a long line of papers.

The second and opposite effect occurs when a controlling shareholder can capture monetary or other private benefits of control, sometimes at the expense of smaller shareholders. As Fama and Jensen (1983) note, a majority shareholder is insulated from the market for corporate control, and commands both decision management (initiation and implementation of decisions) and decision control (monitoring and ratification). Fama and Jensen argue that firms with a majority shareholder cannot exist as publicly traded corporations in equilibrium. The rationale is that an unconstrained majority owner can fully expropriate all assets and cash flows of the company. Small investors will not purchase shares in such companies, which will ultimately be 100% owned by the majority holder. There are many theoretical papers in the corporate governance literature that adopt this view of blockholders (Burkart et al., 1998; Bennedson and Wolfenzon, 2000).

Due to the proliferation of concentrated firm ownership and controlling shareholders in most countries (La Porta et al., 1999), it is important in the study of corporate governance to determine which effect dominates in a particular setting. Previous empirical studies have examined this question, but have come up with conflicting results. On one hand, Holderness and Sheehan (1988, 2000) study majority shareholders in U.S. publicly traded corporations and provide empirical evidence that broadly supports the monitoring view of blockholders and contradicts the expropriating view. DeAngelo et al. (1984) also find that large investors and minority shareholders share most of the gains in LBO transactions, and Mitton (2002) shows that outside blockholders improve firm performance during the Asian crisis. On the other hand, a large literature focusing on the value of voting rights documents that large investors enjoy private benefits of control. In particular, studies