Journal of Economic Behavior & Organization 133 (2017) 87–107

Contents lists available at ScienceDirect

Journal of Economic Behavior & Organization

journal homepage: www.elsevier.com/locate/jebo

Agency problem and ownership structure: Outside blockholder as a signal☆

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ARTICLE INFO

Article history:
Received 22 April 2015
Received in revised form 27 July 2016
Accepted 24 October 2016
Available online 27 October 2016

JEL classification:
D82
G32
G34

Keywords:
Agency problem
Blockholders
Monitoring
Ownership structure
Asymmetric information

ABSTRACT

We model the decision of an entrepreneur, seeking outside financing, on whether to sell a large equity share to a blockholder. A conventional theoretical rationale for the presence of an outside blockholder is mitigation of the agency problem via monitoring. Our model provides a novel insight: outside blockholders may be attracted by entrepreneurs with low, rather than high, agency problems in order to signal their low propensity to extract private benefits. Our result yields a new interpretation of an often documented positive relationship between outside ownership concentration in a firm and its market valuation: it may be driven by "sorting" rather than by the direct effect of monitoring. We show that the positive correlation may arise even if the blockholder derives private benefits and has no positive impact on the value of small shares. Our analysis also helps to explain why the market reacts more favorably to private placements of equity as opposed to public issues.

1. Introduction

It is well documented that firms with blockholders are widespread.[1] The holders of large stakes are often a firm's insiders, i.e., those who control the firm's operations and assets (e.g., managers or family owners closely involved in management). Yet, it is not uncommon for a firm to have *outside* blockholders among its owners.[2]

Why does an outside blockholder emerge in a firm? What determines her share? In the traditional agency theory paradigm, an outside blockholder is an active monitor who restricts managerial (entrepreneurial) private benefit extraction

☆ The study has been funded within the framework of the Basic Research Program at the National Research University Higher School of Economics (HSE) and by the Russian Academic Excellence Project '5-100'. We thank the editor Thomas Gresik, two anonymous referees, Sergei Guriev, Andrei Simonov, Patrick Rey, Jean Tirole, seminar participants at ECARES (Université Libre de Bruxelles), Penn State, conference participants of the 24th Annual Congress of the European Economic Association and the Annual meeting (Retreat) of sister institutes of Stockholm Institute of Transition Economics in 2009.

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[1] See Holderness (2009) for evidence on the U.S., Faccio and Lang (2002), Barca and Becht (2001) on Europe, Claessens et al. (2000) on East Asia. See also La Porta et al. (1999) for evidence in a cross section of developed economies.

[2] For example, in Holderness (2009)'s representative sample of U.S. companies outside blockholders hold 11% of the stock on average. In Lins (2003)'s large sample of companies from 18 emerging markets outside blockholders hold on average 19% of the stock (voting rights).

http://dx.doi.org/10.1016/j.jebo.2016.10.024
0167-2681/

and corrects inefficiencies of the incumbent management. Thus, if ownership structures are chosen so as to mitigate inefficiencies/agency costs within firms, one would expect emergence of an outside blockholder when the agency problem is severe enough or the incumbent management is not sufficiently efficient. This is indeed a feature of many existing theoretical studies in which a blockholder actively intervenes in the governance of the firm.[3] This logic is also in line with the argument in Holmström and Tirole (1997) or Tirole (2006, Ch. 9.2.1), who show that the severity of the agency problem increases the likelihood that the entrepreneur will attract outside monitor in order to be able to raise finance.

There is also more recent literature that examines the role of blockholders as speculative monitors affecting a firm's governance through trading their shares ("exit") rather than intervention ("voice"),[4] but such "passive" monitoring in these models is again a response to one or another type of the agency problem. Edmans (2014) provides an extensive survey of blockholder theories.

Our paper takes the more traditional view of blockholders as active monitors of managers. However, in contrast to the earlier literature, we propose a signaling theory, according to which an entrepreneur chooses to attract an outside blockholder in order to signal his low "propensity to expropriate", that is, low willingness or ability to extract private benefits at the expense of outside shareholders. Thus, relative to the traditional agency theory framework, our theory provides the opposite prediction about the choice of the ownership structure with a blockholder: firms with a *lower*, rather than higher, agency cost are more likely to attract an outside blockholder. Our theory provides a new insight into the determinants of ownership structure and delivers new explanations to some empirical regularities.

We examine the problem of an entrepreneur who wants to raise outside funds by selling equity in order to finance an investment opportunity. The crucial ingredient of our setup is the asymmetry of information between the entrepreneur and the market about the propensity (or ability) of the former to extract private benefits. Under symmetric information, "good" entrepreneurs (i.e. those with a low expropriation propensity) choose not to attract an outside blockholder because they are able to raise finance anyway, and blockholder monitoring is costly (this cost is ultimately born by the entrepreneur though the prices of the offered shares). "Bad" entrepreneurs can raise finance by selling just dispersed equity only when the investment opportunity is good enough. Otherwise, they need to resort to attracting an outside blockholder, because blockholder monitoring becomes necessary for convincing the investors that they will get their money back.

Thus, under symmetric information, in line with the traditional agency theory framework, entrepreneurs with a low agency problem can raise necessary funds without attracting an outside monitor, while firms with a high agency problem need a monitor in order to be able to raise finance.

The asymmetry of information changes the solution radically. When the investment opportunity is good enough, attracting an outside blockholder helps a good entrepreneur to credibly signal his type to the market, because, in this case, a bad entrepreneur prefers being priced fairly and not monitored to pretending to be good but being monitored. When the investment opportunity is not good enough, the separation becomes unfeasible in equilibrium but attracting an outside blockholder may still be necessary for a good entrepreneur in order not to be perceived a bad type (pooling equilibrium). As a result, under asymmetric information, the outside ownership concentration chosen by the good type is never below the level chosen by the bad type and, what is especially remarkable, is even higher for a range of parameters, which stands in stark contrast to the symmetric information outcome.

What is especially interesting, our result holds even when we allow the outside blockholder to participate in the expropriation of small shareholders instead of reducing it. In such a case, monitoring does not increase the value for minority shareholders, but simply helps the blockholder to transfer a part of the private benefits into her pocket. In this setup, the described type of separating equilibrium still exists in a range of parameters, while separating equilibria of other types do not appear.

Our model has implications for two types of empirical regularities: (1) the relationship between outside ownership concentration and a firm's market valuation, and (2) the stock price reaction to private placements of equity.

Several empirical studies find that the presence or a greater equity share of a large outside shareholder is positively related to a firm's market valuation or its operating performance. Lins (2003) finds that large non-management blockholders are associated with a higher firm value in emerging markets. Mitton (2002) documents that stakes held by non-management blockholders were positively related to stock price performance of East Asian companies during the financial crisis of 1997–1998. Becker et al. (2011), examining U.S. data, find that individual (i.e., not institutional) nonmanagerial blockholders positively affect operating performance.

To the extent that the largest firm's shareholder can be considered as an insider/entrepreneur (which is often the case in family firms), empirical studies on the effect of the second largest shareholder are also relevant to us. Lehman and Weigand (2000) using German data conclude that the presence of the second large shareholder improves profitability. In a sample of Finnish firms, Maury and Pajuste (2005) find that a more equal distribution of votes among large blockholders has a positive effect on firm value. Laeven and Levine (2008), in a large sample of firms from 13 Western European countries, find that,

[3] See, e.g., Shleifer and Vishny (1986), Burkart et al. (1997), Pagano and Röell (1998), Bolton and von Thadden (1998), Maug (1998), Aghion et al. (2004), Stepanov (2010, 2013).

[4] See, e.g., Edmans (2009), Edmans and Manso (2011), Admati and Pfleiderer (2009).