International Review of Economics and Finance 51 (2017) 214–234

Contents lists available at ScienceDirect

International Review of Economics and Finance

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

Stock liquidity and second blockholder as drivers of corporate value: Evidence from Latin America

Carlos Pombo [*], Rodrigo Taborda

School of Management, Finance Department, Universidad de los Andes, Bogotá, Colombia

ARTICLE INFO

JEL classification:
G32
G34

Keywords:
Multiple large blockholders
Stock liquidity
Firm value
Corporate governance
Latin America

ABSTRACT

This paper examines the relationship between firm value and blockholders in Latin America. Econometric results for a comprehensive data set of more than 550 firms listed in the six largest stock markets of the region support a positive effect of variables measuring the existence, contestability, dispersion and identity of blockholder on performance (Tobin's Q) only for highly liquid stocks. The identity of the second largest blockholder (family, foreign, financial or the State) emerges as critical for such effects. The study supports that the voice and exit models are complementary rather than substitute mechanisms for firm corporate governance.

1. Introduction

Recent empirical literature on blockholder ownership has focused on the presence of multiple large shareholders and their interactions, and how these can affect firm management either through direct intervention—monitoring—or through share trading. Edmans and Manso (2011), for example, argue that the presence of multiple blockholders creates two conflicting governance effects. In the first, known as the *voice mechanism* or shareholder activism, multiple blockholders serve "as a commitment device to reward or punish the manager ex post for his actions." By contesting control, blockholders can align interests to implement either profitable projects or simply to monitor managers. The second effect, known as the *exit mechanism*, occurs in firms with multiple blockholder structures and sees dispersed (and small) blockholders punish the largest shareholder, or management, by exiting the firm, i.e. by trading their shares, thus affecting firm value. This approach to corporate governance highlights that, by possessing better information about firm value, smaller blockholders can use the exit strategy as a device to discipline the behavior of the largest blockholder. On the one hand, when blockholders contest control, a positive effect on monitoring appears, since the second or third blockholders are given more equal voting rights in circumstances where, due to other mechanisms, they cannot exert absolute control. These mechanisms may include the issuing of non-voting shares or multiple share classes, pyramidal and cross-share ownership structures, or the existence of disproportionate board representation (Villalonga & Amit, 2010).

On the other hand, a negative effect of blockholder ownership may result from the possibility that small shareholders might be subject to expropriation by large shareholders, turning the agency problem from one of controlling blocks to controlling minorities. In such circumstances firm management responds to the interests of the controlling owners, reducing firm value when large shareholders derive private benefits from related party transactions. In addition, an excess of monitoring by blockholders induces a loss of value, since

* Corresponding author. Calle 21 # 1-20, Off. 917, Bogotá, Colombia.
E-mail addresses: cpombo@uniandes.edu.co (C. Pombo), r.taborda@uniandes.edu.co (R. Taborda).

http://dx.doi.org/10.1016/j.iref.2017.05.012
Received 21 November 2015; Received in revised form 10 May 2017; Accepted 18 May 2017
Available online 26 May 2017

management may refrain from certain profitable initiatives when a vigilante approach is followed by large shareholders.

The paradigm of the benefits of a widespread ownership structure, mainly fostered after the prevalent, but not precisely right, view of diffuse ownership in the United States, led the academic agenda to study corporate governance in settings were large shareholders dominate the landscape.[1] At the same time, this view defined a policy agenda towards developing countries in favor of increasing ownership dispersion as corporate governance mechanism. This perspective has evolved in line with the reality of blockholders as the dominant ownership structure in corporate finance. Moshirian, Nguyen, and Zhang (2014) summarize how large ownership is also a prevalent corporate structure in developed countries. The growth of institutional investors worldwide during the last four decades as large shareholders explains in part the presence of blockholder and investor activism within developed capital markets (Aggarwal, Erel, Ferreira, & Matos, 2011).

Under this new reality, whereby widespread ownership has come to be used as a mechanism for increasing corporate governance and ultimately corporate value in developing countries, public policy is at a crossroads. Where to go? Should corporate governance be increased or ownership structures disseminated? The former approach has been widely accepted and implemented in developing countries (McGee, 2009). Whether or not such positive initiatives exist in practice, beneficial effects on corporate value are not guaranteed. The latter approach, on the other hand, cannot be warranted, as a policy interventions aimed at reducing the concentration ownership are hardly an economic policy option. The highly concentrated ownership structure of public and private firms in Latin America provides a useful scenario for an empirical investigation of the association between firm value and ownership in developing countries. Leaving aside the option of dispersed ownership or tighter corporate governance laws or guidelines, the remaining question is how intermediate ownership structures relate to firm value.

Several papers have addressed some of these issues. The blockholder entry and market response was studied by Park, Zekiye, and Moon (2008), showing how the acquirer's profile shapes abnormal returns differently. Ali, Liu, and Su (2017) establish how better governance influence liquidity in Australian listed firms. And extending this work, Nadarajah, Ali, Liu, and Haung (2016) establish how more liquid firms have lower leverage once corporate governance mechanisms are accounted for. Closely related to Latin American experience with corporate governance, the work of Cueto (2013) examines corporate governance and ownership concentration and the effect upon firm value. Given that high ownership concentration is prevalent in the region, the author suggests that to minimize its negative effect, firms engage in corporate governance and institutional investors engage in monitoring and restraint asset appropriation.

The paper contributes to the literature on multiple blockholders in empirically addressing two analytical alternatives that can shed light on approaches to increase firm value under a setting of high ownership concentration in emerging markets. First, we claim that blockholder direct monitoring or voice is an effective channel for reducing shareholders' agency costs and improving firm corporate governance but its effectiveness is conditional to stock liquidity. In other words, contestability among blockholders is only effective and shareholders' exit strategy credible for high liquid stocks within financial markets where capital deepening is a structural issue. Second, we provide evidence that in firms with multiple blockholder ownership structure but without absolute control by the largest shareholder, the type of the second blockholder is central in explaining firm valuation.

Ownership structures in Latin America led us to hypothesize that the second blockholder is crucial in this connection and that the situation described for the region might also elucidate the case of other emerging markets. Nearly 50% of the firms in this study have a controlling blockholder with equity rights above 50%, while fewer than 5% of firms within the sample have no kind of blockholder at all (i.e. all their shareholders have less than 10% of equity). The remaining 45% of firms in the sample exhibit multiple blockholders without direct control, but that are still of considerable size (more than 10% of equity), meaning that there is scope for forming controlling coalitions among the largest blockholders. The frequency distribution of ownership within this last group of firms shows that when the largest voting block colludes with the second largest, the coalition represents around 45% of direct votes, a figure that rises to 54% when the third top blockholder is included. High ownership concentration implies low separation ratios between ownership and control. Empirical country-level case studies on corporate ownership in Latin America, based on real sector firms, show that separation ratios between ownership and control are close to 0.85 (Gutierrez and Pombo, 2009). This means that a controlling shareholder will need 42% of equity rights if they are to obtain control over a firm's voting rights. Thus, focusing the empirical analysis on the role of blockholder coalitions and their effects on firm value, measured by direct votes, is fully justified by the circumstances on the ground.[2]

Our work extends prior results of benchmark studies of multiple blockholders and firm value. Maury and Pajuste (2005) based on a sample of 136 Finnish firms for the 1993–2003 period, found that contestability and blockholder dispersion reduces firm value. They only report the regression coefficients and direct effect through Shapley coalitional value, the Herfindal concentration and the differences in shareholder rights indices. There is no discussion on the role of stock liquidity. Similar results were found by Laeven and Levine (2008) for a sample of 1657 European firms but these results were limited to estimates for a cross section. The authors report a negative premium of cash flow rights dispersion between the largest and second largest blockholder on firms' Tobin's Q without the presence of a controlling owner with majority control rights (ownership share > 0.50). They did not consider any discussion on the role of market liquidity and blockholder trading as a blockholders' disciplinary device. Konijn, Kräussl, and Lucas (2011) study the influence of blockholder presence, size and dispersion on firms' Tobin's Q based on a sample of 3772 firm-year observations of US listed companies. They found a negative correlation between blockholder presence and size on firm value. They disentangle the blockholder effect produced by insiders and outsiders, where the former have a positive effect of firm value offset by the negative effect of outsiders. They

[1] An example of the argument that ownership is widespread is provided by the work of Becht (2001), while Holderness (2009) has been pivotal in debunking this view.

[2] Indirect estimation of the wedge between ownership and control puts it at 0.75 - similar to the results of direct measurement. The indirect wedge indicator is defined as the Shapley value solution of a four-voting oceanic game to largest shareholder cash flow rights (Guedes & Loureiro, 2006).