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Reading between the blocks☆

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ABSTRACT

We examine the influence of multiple blockholders on the ownership-firm value relationship for a comprehensive sample of US firms. Additional blockholders can either form a coalition with or monitor the largest individual blockholder. The choice between these alternatives influences the manner in which ownership affects firm value. Further, the choice between coalition formation and monitoring is influenced by blockholder identity – individual blockholders tend to form a coalition with while corporate blockholders tend to monitor the largest individual blockholder. Even among individual (corporate) blockholders, there is significant variation in the probability of coalition formation (monitoring). Overall, our findings suggest that the ownership-firm value relationship critically depends on the presence and identity of additional blockholders.

1. Introduction

Much of the existing literature on the relationship between ownership and firm value has framed the issue as a trade-off between two opposing effects – incentive alignment and entrenchment.[1] As noted by Fama (1980), both of these effects are likely to be influenced by the interactions between shareholders, who may either agree to act in unison or monitor each other.[2] Despite the potential importance of such interactions, prior literature has largely remained silent on the empirical aspects of this matter.[3] Using a comprehensive sample of US firms, we fill this gap in the literature. We examine how the relationship between the ownership of the largest individual blockholder and firm value is influenced by the presence and identity of additional blockholders.[4]

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[1] Jensen and Meckling (1976) argue that the greater is the size of the blockholder's stake, the greater is the focus on creating value over the long-term rather than extracting private benefits. Conversely, Morck, Shleifer, and Vishny (1988), Stulz (1988), and McConnell and Servaes (1990) each argue that higher levels of ownership increase blockholder power, leading to entrenchment and value-decreasing perquisite consumption at the expense of minority shareholders. The dominating effect still remains an empirical question.

[2] Bennedsen and Wolfenzon (2000) argue that blockholders may attempt to form coalitions that can extract private benefits from the remaining shareholders. Bloch and Hege (2001) argue that blockholders compete for control of the firm and thus the presence of multiple blockholders would act as a check on the rent extraction by the controlling blockholder.

[3] For a notable exception, see Kim and Lu (2011).

[4] We choose to base our analysis on the relationship between the ownership of the largest individual blockholder and firm value for two reasons. First, such a blockholder is arguably the most influential blockholder in the firm who is subject to both considerable incentive alignment and entrenchment effects. Second, by focusing on such a relationship we also avoid contamination by the interactions we are attempting to investigate.

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Our results indicate that additional blockholders influence this relationship either by reducing the entrenchment effect through monitoring or by forming positive or negative coalitions with the largest individual blockholder.

We begin by defining a coalition as an agreement between blockholders to act based on the combined level of their ownership, as opposed to their individual stakes. Such an agreement can have either a positive or negative influence on firm value as the blockholders may agree to act in unison to extract private benefits (we will refer to this case as a negative coalition) or to increase the value of the firm (positive coalition). Thus, our definition of coalition encompasses both the potential benefits generated for and the costs imposed on the firm through blockholder cooperation. Further, it is possible that the additional blockholders remain passive, either because they choose to do so or because their ownership stake is not large enough to influence the actions of the largest blockholder. In both cases, the largest individual may deem the passive blockholder's lack of resistance as an implicit agreement and therefore will act based on their combined ownership level. We refer to such situations as implicit coalitions.[5]

Coalition formation will reinforce the relationship between the ownership of the largest individual blockholder and firm value observed in a firm with a single blockholder.[6] In particular, it will make both the entrenchment and the incentive alignment effects more pronounced since the coalition will now act based on their combined ownership levels as opposed to only that of the largest blockholder. The formation of a coalition, however, is not the only possible outcome in the presence of an additional blockholder – an additional blockholder may also be an effective monitor of the largest one. Such monitoring will limit the negative effects of entrenchment on firm value, subject to the monitoring blockholder's ability to influence the actions of the largest blockholder. Further, the propensity to form coalitions or engage in monitoring will depend upon the identity of the blockholder.[7] More specifically, the following three characteristics make corporate blockholders less likely to engage in the formation of a coalition. First, they are seldom firm insiders and thus are unlikely to reap private benefits of control. Second, their shorter investment horizon is likely to make any coalition between them and the largest blockholder relatively short-lived. Therefore, the two parties may find it too costly to form a coalition. Third, corporate blockholders may have external pressures (e.g., fiduciary obligations) that make them less likely to form a coalition with, and more likely to monitor, the largest blockholder. As a result, we expect individual (corporate) blockholders to be more likely to form a coalition with (monitor) the largest blockholder. Finally, we hypothesize that the *identity* of the additional individual or corporate blockholders will also have a significant influence on the observed ownership-firm value relationship. We develop formal hypotheses in Section 2.

Before describing the influence of additional blockholders on the ownership-firm value relationship, it is important to talk about the relationship itself. An aspect of the existing literature relevant for our study is the dependence of the shape of the relationship upon sample selection criteria. Studies using samples of large and index-listed firms tend to find a statistically significant concave (inverse U-shaped) ownership-firm value relationship (e.g., McConnell and Servaes, 1990; Anderson and Reeb, 2003; and Kim and Lu, 2011), while those using random samples tend to find an insignificant one (e.g., Himmelberg et al., 1999).[8] Further, studies on the relationship between ownership and performance in private and newly public firms tend to find a convex (U-shaped) relationship (e.g., Nagar et al., 2011; Basu et al., 2009).[9] Since our sample – a complete cross-section of all firms listed in the Compustat and Center for Research in Security Prices (CRSP) databases – includes many small, young, and non-index-listed firms, our finding of a statistically significantly convex ownership-firm value relationship is not surprising.

We find that, depending on the presence or absence of additional blockholders, there indeed is a significant variation in the ownership-firm value relationship. First, we find that in the presence of an additional individual blockholder, the ownership-firm value relationship becomes more convex. Second, we find that the presence of a corporate blockholder counteracts the negative influence of the entrenchment effect at intermediate levels of the largest blockholder's ownership, consistent with the benefits from monitoring by the corporate blockholders being largest at this level of ownership. Taken together, our results are consistent with the conjecture that individual blockholders are more likely to form coalitions as compared to their corporate counterparts. Further, we find that the identity of the blockholder matters. In particular, family blockholders are more likely to engage in coalition formation, both as the largest and second-largest individual blockholder. Our results also indicate that two individual blockholders of the same type (family, outsider, or non-family insider) are more likely to form a coalition than are individual blockholders of different types. Finally, we find that venture capital and private equity blockholders are better monitors, on average, than other corporates, while employee stock options plans (ESOPs) do not appear to monitor.

Our paper is related and contributes to several streams of research. The first is the extensive literature on the relationship between (insider or CEO) ownership and firm value.[10] The issues inherent in this literature are perhaps best summarized through the following example. According to the 2004 proxy statement of Coca-Cola Company (KO), the firm's CEO, Mr. Douglas N. Daft

[5] Empirically, it is not possible to distinguish between an active and a passive or implicit coalition. Therefore, all of our results should be interpreted with this caveat in mind.

[6] In the rest of the paper, we use "the relationship between ownership of the largest individual blockholder and firm value" and "ownership-firm value relationship" interchangeably.

[7] We define a corporate blockholder as a corporate entity not affiliated with any of the individual blockholders. These include, among others, institutional (financial) investors, such as mutual and pension funds, and various private and public non-financial corporations.

[8] As reported by Dlugosz et al. (2006), data quality issues also have a significant influence on the estimated ownership-firm value relationship.

[9] Nagar et al. (2011), in their analysis of small, closely-held firms, find evidence of better firm performance at low and very high ownership levels as compared to intermediate ones. Basu et al. (2009) find evidence consistent with a convex relationship between family ownership and firm value in newly public US firms. Evidence consistent with a convex relationship is also provided by Slovin and Sushka (1993), who find that the market reaction upon the announcement of a blockholder's death is a concave function of his ownership stake and "that firm value reaches a minimum when insider ownership is 40%" (p. 1304).

[10] For excellent summaries of this stream of research, see surveys by Shleifer and Vishny (1997) and Denis and McConnell (2003).