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Controlling shareholders' value, long-run firm value and short-term performance

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ABSTRACT

We propose a new determinant of firm value within a business group: controlling shareholders' value (CSV), the value of controlling shareholders' stake in an affiliate divided by their stake in all affiliates. We posit that controlling shareholders focus attention on the high-CSV affiliates. Using data on Korean family-controlled business groups, we find that CSV has greater explanatory power for firm performance than traditional cash flow rights (CFR). We also find that, among affiliates with non-family CEOs, higher CSV is associated with higher Tobin's Q and lower EBITDA, indicating that controlling shareholders and non-family CEO have successfully addressed their principal-agent problem.

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1. Introduction

We propose a new determinant of earnings and firm value among the affiliate firms of a business group: controlling shareholders' value (CSV), or the value of the controlling shareholders' shareholding in each affiliate divided by the combined value of the controlling shareholders' shareholdings in all of the affiliates in the group. This contrasts with the commonly used notion of cash flow rights (CFR), the percentage of the shares of a given affiliate owned by the controlling shareholders. We argue that both CSV and CFR must be taken into account to develop a full picture of the short-term performance and long-term firm value of the affiliates within a business group.

Suppose a controlling shareholder has two affiliates A and B, whose equity values are \$1 billion and \$10 billion, respectively. Suppose she owns 50% of A and 30% of B, so her CFRs are $CFR_A = 50\%$ and $CFR_B = 30\%$. Her CSV in A is $CSV_A = \$500$ million/\$3.5 billion = 14.3%, while her CSV in B is $CSV_B = \$3$ billion/\$3.5 billion = 85.7%.

Recent theoretical literature considers the effects of limited attention span (see DellaVigna, 2009). The controlling family of a large, heterogeneous business group cannot devote full attention to every affiliated firm; thus, attention becomes a scarce resource. Assuming that a given amount of attention increases the long-run value of each affiliate by the same percentage, the optimal strategy would be to pay the most attention to those affiliates in which the controlling family's CSV is highest.[1] The

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[1] When we calculate controlling shareholders' holdings in an affiliate, we include both direct and indirect investments by other affiliates.

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controlling shareholder would rather pay close attention to B instead of A, since a 1% increase in the value of B increases her long-run portfolio value by $30 million, while a 1% increase in the value of A increases her long-run portfolio value by $5 million.

Most of the literature on large Korean business groups has focused on how CFR affects the Type II agency problem between controlling and outside shareholders, and has documented the existence of tunneling and propping in cash-flow expenditures among affiliates.[2] In this paper, we focus more on how CSV affects the Type I agency problem between controlling shareholders and the CEO. To the best of our knowledge, this is the first paper to examine CSV in affiliates, and whether CSV affects the long-run value or short-term performance of those affiliates.

The most pressing concerns facing shareholders and CEOs are optimizing short-term performance (proxied by EBITDA) and long-run firm value (proxied by Tobin's Q). Narayanan (1985) suggests that American managers tend to make decisions that yield short-term gains at the expense of the long-term interests of the shareholders. Bolton and Samama (2013) argue that excessive focus on short-term performance has had adverse economic consequences: "Financial policy makers, regulators, academics, and other market observers have long expressed concern that, particularly in capital market-driven economies like the U.S. and U.K., excessive focus on quarterly earnings and short-term stock price has led to corporate underinvestment—and, as a result of such underinvestment, disappointing growth in GDP and jobs."[3] Kay (2012) reaches similar conclusions about the UK economy.

When a business group is controlled by a single family, the family expects to maintain control over the long run and hence should focus its attention on maximizing the long-run value of the business group; moreover, it should be willing to tolerate weaker short-term group performance when doing so will enhance long run value. This focus on the long run may partly explain the success of Korean family-owned business groups, and their contribution to the growth of the Korean economy.

However, it is not enough that the controlling shareholders *desire* a focus on long run value. They must induce the CEOs of the affiliated firms to *act* in a way that maximizes long run value. When the firm CEO is a family member, the CEO's interests are aligned with the family's interests.[4] By contrast, non-family CEOs may view their jobs and shareholdings as transient, and thus focus more on short-term performance, resulting in a Type I agency problem.

The controlling shareholders can ameliorate the Type I agency problem with a non-family CEO by paying close attention, to ensure that the CEO focuses on long-run value, even at the expense of short-term performance. Since attention is a scarce resource, the controlling shareholders should apply more attention to the affiliates with higher CSV. This attention is not intended to enhance the *skills* of the CEO; after all, the outside CEO was presumably chosen because he or she was a more skillful manager than the available family members. Rather, the attention is intended to ensure that the CEO uses his or her high skill to enhance long run value, rather than short-term performance.

When a firm CEO is a member of the controlling family, the Type I agency problem is eliminated.[5] The family CEO is presumably at least as skilled as other available family members. Thus, attention is unlikely to improve decision-making. For this reason, we might expect to see attention on the part of the controlling shareholders play a smaller role in affiliates with a family CEO. How the CSV effect plays out in the two groups, family versus non-family CEO, is an empirical question. For this reason, our analysis treats the two groups separately.

This leads us to the main contribution of this paper, hypothesizing the CSV effect: among business group affiliates, those with the largest CSV exhibit higher Tobin's Q and lower EBITDA.

In this paper, we study the Korean business groups known as chaebols. Chaebols are large conglomerates with exceptionally broad scope controlled by members of a single family. Despite their very broad scope, discussed further in Section 2, Korean chaebols have been enormously successful.[6,7] They have played, and continue to play, the major role in the rapid economic development of Korea. This makes chaebols a fertile subject for the study of the governance of a large and very complex business. What determines how well a vast family-controlled conglomerate and its individual affiliates perform? What determines the trade-off between long-term value and short-run performance? How well do chaebols handle the various principal-agent problems? How, and how well, do they allocate attention? How do family-managed affiliates compare with those managed by non-family CEOs?

[2] Related studies define tunneling as the transfer of wealth from an affiliate with a small CFR to another with a large CFR. Propping is defined as the transfer of wealth from an affiliate with a large CFR to another (often facing some financial distress) with a small CFR (Johnson et al., 2000; Friedman et al., 2003). Many studies have provided supporting evidence of tunneling in various international contexts. Johnson et al. (2000), Faccio et al. (2001), and Claessens et al. (2002) provide it in the context of Asia. For example, Bae et al. (2002a) and Baek et al. (2006) present evidence of tunneling in Korea, and Bertrand et al. (2002), Cheung et al. (2006), and Bertrand et al. (2008), in India, Hong Kong, and Thailand, respectively. Johnson et al. (2000) and Faccio et al. (2001) provide evidence of tunneling in Europe, and Attig (2007), in Canada. Friedman et al. (2003) and Riyanto and Toolsema (2008) present evidence for propping. Bae et al. (2008) present that earnings surprise of an affiliate of a Korean Chaebol has a positive effect on the market value of its other affiliates; such transfer of wealth, if it happens, is propping. Dow and McGuire (2009) claim that affiliates of Japanese keiretsu choose tunneling in good times but choose propping in downturns. Gopalan et al. (2007) show that propping occurs in Indian business groups via lending and borrowing among affiliates.

[3] They argue that long-term shareholders create a positive externality, and that compensation (in the form of additional dividends or warrants) should be provided to incentivize long-term shareholding.

[4] With a family CEO, there is a Type II agency problem but no Type I agency problem.

[5] However, the agency problem between the CEO and outside shareholders increases when the CEO is a member of the controlling family. See Section 2 for a discussion of agency problems in the context of Korean chaebols.

[6] The contribution of chaebols to the Korean economy is overwhelming and continues to grow. The top five chaebols accounted for 49.1% and 60.7% of Korea's GDP in 2001 and 2011, respectively. In 2011, the top five were Samsung, Hyundai Motor, SK, LG, and Lotte; note that the first, second and fourth of these have become well-known brands internationally.

[7] In 2011, Samsung Group controlled 81 affiliates in 27 different industries. Similarly, Hyundai Motor Group and SK Group controlled 56 affiliates in 26 industries, and 94 affiliates in 34 industries, respectively.

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