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Ownership and control in Central and Eastern Europe

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ABSTRACT

The unique natural experiment of the fall of the iron curtain led to large institutional and governance differences across countries. This allows us to observe the evolution of ownership and control after an initial shock. We utilize this cross-time/cross-country variation in institutions and privatization methods to analyze the determinants and effects of individual investor control in a large sample of firms in 11 CEE countries over the period 2000–2007. Controlling for possible endogeneity and firm effects, we find that large individual investors add value to the firms they control. They do so predominantly compared to state controlled firms but also compared to other privately controlled firms. If large individual investor firms employ professional managers and (only) supervise them actively, they achieve the better performance improvements in Tobin's q than the firms managed by their controlling shareholders. Concerning the determinants of ownership, large individual shareholders substitute for missing good country governance institutions, and ownership is very sticky, since initial conditions (privatization methods) still matter. It appears that secondary markets do not converge on the same ownership equilibria as primary markets do.

1. Introduction

The extant literature on ownership structures around the world documents that a significant part of the largest public companies are controlled by a family or an individual.[1] However, there are significant cross-country differences in the prevalence of controlling shareholders, as documented in La Porta et al. (1999). The analysis of the determinants of controlling shareholders is difficult, since country characteristics and ownership structures evolve jointly over long periods of time and thus the issue of endogeneity is particularly severe. Similar issues arise when the effect of controlling shareholdings on firm performance is analyzed.

In this paper we shed new light on these questions by providing the first cross-country evidence on ultimate ownership in Central and Eastern European Countries (CEEC). The unique natural experiment of the fall of the iron curtain led to large institutional and governance differences across countries. This allows us to observe the evolution of ownership and control after an initial shock.

The main goal of this paper is twofold. First we systematically identify the ultimate owners of the largest listed companies in Central and Eastern Europe as they have evolved after nearly two decades of transition, and analyze the determinants of large individual investor control. We deliberately do not speak of "family"-control but instead of "large individual investor"-control,

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[1] La Porta et al. (1999) provide evidence that the largest companies in 27 developed and developing countries tend to be controlled by a family/individual or the state. Claessens et al. (2002) find that more than half of East Asian corporations are controlled by a family. Faccio and Lang's (2002) work reveals that most of the largest companies in Western Europe are controlled by a family followed by widely held firms.

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since the classical family-founded and -controlled company would not be an appropriate description of the firms encountered in CEE countries. The large individual investor controlled firms we analyze are mostly formerly state-controlled firms, which were privatized in the 1990s.

Second, we explore the effects of large individual investor control on performance, accounting for potential endogeneity of control. Claessens et al. (2002), Amit and Villalonga (2006) and Anderson and Reeb (2003) conclude that the relation between family control and performance cannot be well understood without distinguishing between ownership, control, and management. Therefore, we further analyze the determinants and the effects of the concentration of large individual investor control versus cash flow rights, and the participation of the large individual investor on the management or the supervisory board. Our analysis on determinants of ownership closely relates to Boubakri et al. (2005), who explore the post privatization ownership structure and its determinants in 25 emerging markets. However, we further consider the impact of the large individual investor on performance and the determinants of his role in the firm.

Our interest in CEE firms is due to the specific legal and economic environment in which they operate. These countries underwent a transition process from planned to market economy. The transition process and the privatization led to dynamic changes and adjustments in the control and ownership structures of companies as well as country institutions, a process which is still continuing. The development of the capital markets in these countries is intrinsically associated with the privatization process, since a significant part of the listed companies are privatized former state-owned companies. The capital markets in CEE countries are rather illiquid, characterized by a limited number of actively traded companies. Moreover, the number of listed companies has decreased significantly after the mass privatizations. After two decades of transition, the legal and regulatory framework of most transition countries is as good as in Western European countries, however the quality of law enforcement is still rather low. CEE countries rank better in corporate governance than countries with similar income but lower than the countries in Western Europe (Stulz, 2005). With respect to the rule of law and corruption the countries in Central and Eastern Europe rank slightly better than countries with similar income. Berglöf and Pajuste (2005) find that firms in a number of CEE countries disclose less than the law requires them to disclose, so the disclosure laws do not seem to be well enforced. The privatization process, lax legislation and low transparency may have created favorable conditions for the concentration of ownership and control. In such an environment large individual investors may play an important role in providing funds and solving informational problems. Hence, the CEEC provide a unique opportunity to utilize the resulting unique cross-firm, cross-country, and cross-time variation, and test for the effects of institutional and market evolution as well as the initial conditions (privatization methods) on large individual investor control incidence. We use a data set which encompasses the largest public companies in eleven CEE countries reported in Amadeus. The predominant shareholders of the largest public companies in CEECs are firms ultimately controlled by a family or an individual (34.62%). A distinct feature of the sample is the still significant control of the state (32.9%).

The weak institutional environment is one of the factors that explains concentrated ownership (Boubakri et al., 2005; Burkart et al., 2003; La Porta et al., 1997, 1999). Recent papers found contradicting evidence on the effect of the institutional environment. Masulis et al. (2009) show that market development is an important factor for the existence of family business groups, while the institutional environment only has an indirect effect. Amit et al. (2009) document that institutional efficiency has a positive impact on the formation and survival of family firms in China. In a cross-country, time series regression framework, we find that large individual investors are more prevalent in countries characterized by a weaker legal environment and less developed financial markets. Controlling for possible self-selection biases as well as firm and industry characteristics, we find that large individual investors enhance firm value (Tobin's q). They do so not only compared to state controlled firms, which with the exception of anonymously controlled perform worst, but also compared to all other firms such as foreign controlled firms. We further document that the relation between large individual investor control rights and firm value is non-monotonic.

There are competing arguments on whether concentrated management ownership is beneficial or detrimental to a firm's value to outside investors. Some papers highlight that founder CEOs solve problems associated with the separation of ownership and control, and have a positive impact on corporate performance (e.g. Amit and Villalonga, 2006; Anderson and Reeb, 2003; Morck et al., 1988; Palia and Ravid, 2002). Morck et al. (1988), however, also show that the relation between Tobin's q and management ownership is non-monotonic, since after a threshold of management ownership the entrenchment effect outweighs the incentive effect. Peng and Jiang (2010) find that family-CEOs are only value enhancing in underdeveloped countries, while they do not have significant effects in more developed countries. We go one step further and analyze the circumstances when, large individual investors increase performance most. Our analysis reveals that firms in which the large individual investors are part of the management board underperform the other firms controlled by individual investors, where he sits either only on the supervisory board or is formally passive.

The individual investor firms in CEEC use various control enhancing mechanisms, the most important ones are pyramids. Claessens et al. (2002) investigate the role of pyramids in Asian firms, and find that firm value falls when the control rights of the largest shareholder exceed his cash flow rights (i.e. if there is a “wedge”). Mitton (2002) finds similar results for returns to shareholders. Lins (2003) further shows that effects are weaker in countries with better legal protection and in pyramids with large outside shareholders. Consistent with prior research we confirm that the wedge between family control and cash flow rights has a detrimental impact on firm value.

Finally, one important finding of this study is that ownership and control structures are path dependent. We find that initial (i.e. in the early 1990s) primary privatization methods still determine ownership and control structures more than one decade later. It appears, therefore, that initial conditions are very important for the evolution of ownership and control structures. Put differently, once countries are trapped in sub-optimal ownership structures, they remain trapped for a long period of time.