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Do controlling shareholders' expropriation incentives imply a link between corporate governance and firm value? Theory and evidence ☆

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ABSTRACT

We develop and test a model that investigates how controlling shareholders' expropriation incentives affect firm values during crisis and subsequent recovery periods. Consistent with the prediction of our model, we find that, during the 1997 Asian financial crisis, Asian firms with weaker corporate governance experience a larger drop in their share values but, during the post-crisis recovery period, such firms experience a larger rebound in their share values. We also find consistent evidence for Latin American firms during the 2001 Argentine economic crisis. Our results support the view that controlling shareholders' expropriation incentives imply a link between corporate governance and firm value.

1. Introduction

Researchers have extensively examined the link between corporate governance and firm value during an economic crisis. Previous studies show that firms with weaker corporate governance suffer more during such a period. One potential explanation for this finding is that, during a crisis period, controlling shareholders' incentives to expropriate minority shareholders tend to go up as the expected return on investment falls (Johnson, Boone, Breach, and Friedman, 2000; Mitton, 2002; Baek, Kang, and Park, 2004). This view implies that controlling

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shareholders' incentives to expropriate minority shareholders are the key channel through which corporate governance affects firm value during a crisis period. We term this conjecture the expropriation hypothesis.

However, the positive relation between the quality of corporate governance and the change in firm value during a crisis period is also consistent with several alternative explanations. One such explanation is an information-based argument. For example, prior to the 1997 Asian financial crisis, the relation-based financial system in East Asia worked well and, thus, investors might have ignored the weaknesses of East Asian firms. Alternatively, perhaps investors did not have full information on whether or not their funds were being deployed appropriately, but the crisis exposed the inherent weakness in the corporate governance systems of East Asian countries, triggering greater investor awareness of the problems in the region. This increased awareness led to investors' pulling out (Rajan and Zingales, 1998). This argument suggests that greater investor awareness of the weakness in corporate governance is the main driving force that links corporate governance to the change in firm value during the crisis period. According to this view, the poor performance of firms with weak corporate governance during a crisis period is not necessarily due to increased expropriation, but rather to investors' paying more attention to corporate governance problems that have been hidden.

Another potential explanation is that the governance measures used in previous studies are somehow closely correlated with firms' sensitivity to business conditions. For example, in our sample firms, we find a strong negative correlation between firm-level governance measures and systematic risk as estimated by the market model beta. This finding suggests that the performance of poorly governed firms is more sensitive to change in market conditions, implying that firms with weaker corporate governance suffer more when the market performs poorly.

Finally, it could simply be that investors overreact to a shock, and the degree of investors' overreaction is more pronounced for poorly governed firms. Like other explanations, overreaction also implies a positive relation between the change in a firm's value and the quality of its corporate governance during a crisis.

While both the expropriation hypothesis and the alternative explanations have important implications for the link between corporate governance and firm value during a crisis, previous research has largely overlooked these alternative explanations in examining that link. In this paper, we reevaluate the validity of the expropriation hypothesis by developing and testing a model that considers the expropriation incentives of controlling shareholders not only during the crisis period, but also during the subsequent recovery period. In our tests, we explicitly consider the possibility that firms with weaker corporate governance suffer more during economic crisis periods because of the alternative reasons.

The novelty of using the post-crisis recovery period is that the prediction of the expropriation hypothesis regarding the relation between the quality of corporate governance and the change in firm value during this period is exactly opposite to that during the crisis period. If controlling shareholders' increased incentive to expropriate minority shareholders during the crisis period is the main reason for the poor performance of firms with weak corporate governance, we would expect these firms to experience a larger percentage increase in value during the recovery period than do firms with good corporate governance. This prediction does not imply that poor corporate governance enhances firm value during the recovery period. Instead, our model suggests that the greater rebound in the stock prices of firms with weaker corporate governance during the recovery period is a reflection of the firms' more rampant asset diversion problem during the crisis period, which severely limits their ability to take full advantage of the substantially improved investment opportunities when recovery begins.

The rationale for this prediction is as follows. During the crisis period, because of the significant decline in firms' profit prospects and poorer investment opportunities, controlling shareholders have stronger incentives to divert firm resources for their own benefits. Consequently, firms with weaker corporate governance experience more asset diversion and larger decline in firm value than those with better corporate governance. However, as the economy recovers, firms' profit outlook and investment opportunities improve substantially. Because controlling shareholders can benefit more from profitable firm investments than from expropriation during this recovery period, the improved economic conditions alleviate controlling shareholders' incentives to expropriate minority shareholders. Because firms with weaker corporate governance had more extant asset diversion before the recovery period, during the recovery period they have limited resources for undertaking all the profitable investments available and are thus forced to undertake only the most profitable ones. As a result, during the recovery period, on a per dollar basis, firms with weaker corporate governance realize higher returns on investments than those with better corporate governance and, thus, experience greater percentage increases in firm value.

The case of Samsung Fine Chemical (SFC) illustrates how firms with weak corporate governance experience large declines in firm value during the crisis period but have strong rebounds as the economy recovers. In 1996, a year before the onset of the Asian financial crisis, the controlling shareholders of Samsung Group directly and indirectly (through firms affiliated with the business group) own 0.07% and 8.49%, respectively, of the outstanding shares of SFC, and the affiliated firms additionally hold 32.47% of its outstanding shares. This ownership structure (i.e., divergence between ownership and control) allows controlling shareholders to exercise full control over SFC despite holding a relatively small portion of its cash flow rights. During the crisis period, the stock price of SFC plummeted from 29,500 won in July 1997 by almost 74% to just above 7,700 won by the end of September 1998. However, as the economy recovered, the stock price of SFC bounced back strongly, reaching 26,600 won (an increase of 245%) by the end of December 1999. In comparison, the increase in the Korean stock market index during the same period was 152%.