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The effect of ownership and control on market valuation: Evidence from initial public offerings in The Netherlands

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Abstract

This study examines whether ownership and control variables influence market valuation at the time of the initial public offering (IPO). Using a sample of 118 IPOs on Euronext Amsterdam during the period 1984–2001, we find support for this conjecture. Management stock ownership, the proportion of independent supervisory directors, and board monitoring by large nonmanagement shareholders are positively related to IPO firm value. These factors are successful in reducing agency costs. We also find that supermajority management stock ownership and takeover defenses lower IPO firm value. Therefore, these mechanisms increase agency costs, resulting in a lower price that investors are willing to pay for IPO shares.

JEL classification: G32; G34
Keywords: Initial public offering; Agency costs; Firm valuation

1. Introduction

At the time of an initial public offering (IPO), managers seek to raise capital from a large group of outside investors and/or to sell part of their shareholdings. These managers are used to having matters their own way in a privately held business and are likely to manage the IPO firm to their personal benefit as if it were still privately held rather than

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allowing outside investors to limit their autonomy. This initiates an agency conflict between managers and outside investors (Mello & Parsons, 1998; Pagano & Röell, 1998).

The proposed issue of securities by IPO firms is similar to the situation modeled by Jensen and Meckling (1976), where an existing owner-manager is planning to sell equity to outside investors. Outside investors are aware that the owner-manager may pursue personal benefits and take corporate actions that are not in their best interest. Jensen and Meckling argue that investors will lower the price they are prepared to pay for the shares to incorporate any agency costs they will have to incur to monitor the behavior of the manager. Similarly, investors will factor the cost of the owner-manager diverging from their interest that cannot be cost-effectively eliminated through monitoring (residual loss) into the price for IPO shares. The ownership and control structure of IPO companies plays an important role in controlling these agency costs.

This gives managers an incentive to control the agency problem by accepting limits on their ability to exclusively determine corporate policy. In this study, we investigate whether adding independent directors to the board of the IPO firm (directors who monitor managers and do not have a direct link with the company) is effective in reducing agency costs. We also examine whether having a large nonmanagement shareholder on the board is successful in controlling the agency problem. Additionally, we investigate whether the bonding activities of management can control the agency problem. Managers can bond to the IPO firm by retaining an ownership stake in the company rather than selling out at the IPO. Because managers internalize most of the value effects of their decisions through their retained ownership, it provides a guarantee that they will make corporate decisions with intent to increase value to all shareholders instead of pursuing private benefits (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2002). Assuming that these ownership and control mechanisms reduce agency costs, they raise the price that investors are willing to pay for IPO shares.

Alternatively, management may value private benefits of control that much that they are willing to bear the increased agency costs and lower price for the IPO shares (Bebchuk, 1999). For example, managers may decide to keep a majority-voting stake in the company or adopt takeover defenses to ensure their controlling position. This shields management from the market for corporate control because a takeover bid can only succeed if the bidder successfully acquires a majority of the shares. We examine whether the retention of a majority ownership stake and the use of takeover defenses increase agency costs and thus negatively impact IPO firm value.

We analyze a sample of 118 IPOs on Euronext Amsterdam during the years 1984–2001. The Dutch situation is interesting. First, companies are required to adopt a two-tier board structure (consisting of a management and supervisory board). The supervisory board is expected to actively monitor the management board and consists of nonexecutive directors only. Second, companies from the Netherlands may choose to adopt takeover defenses that limit minority shareholders' rights even when there is no current hostile takeover bid. Takeover defenses can therefore be used by managers to continue their controlling positions and maintain their decision-making autonomy. Our main contribution to the literature is that we provide a more direct test of the principal–agent theory that closely resembles the situation modeled by Jensen and Meckling (1976). In particular, we examine how various ownership and control variables relate to firm value at the time of the