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**Corporate Ownership Structure and**

**Performance in Europe**

**Jeremy Grant and Thomas Kirchmaier**

**Abstract**

In this paper, we show that ownership structures vary considerably across Europe and that ownership has a significant impact on firm performance. We observe that ownership structures in Europe are not consistent with value maximisation principles. Ultimately, our results show that dominant shareholders destroy value. These findings are in contradiction to similar research based on US samples. Our results remain robust after controlling for industry and country effects, liquidity, and the type of owner. We base our analysis on a new and unique dataset of uniform ownership data of the largest 100 firms in the five major European economies. We quantify the differences in ownership by comparing three distinct ownership structures of firms and relating them to performance. For the first time we employ a Hodrick-Prescott Filter, a methodology widely used in macroeconomics to isolate the trend growth components from cyclical fluctuations, to estimate the share price trend of each firm. We take this trend as a good indirect indicator of the quality of governance.

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# Corporate Ownership Structure and Performance in Europe

## Jeremy Grant
## Thomas Kirchmaier

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*The value of the shares is not important because people are not interested in buying our shares and we are not interested in trying to promote the value of our shares.*

Vincent Bollore, French Corporate Raider, on his family's publicly listed company (Simmons and Silver, 2003)

*Shareholders are stupid and impertinent - stupid because they give their money to somebody else without any effective control over what this person is doing with it - impertinent because they ask for a dividend as a reward for their stupidity*

Carl Furstenberg, German Banker (Zingales and Rajan, 2003)

# CORPORATE OWNERSHIP STRUCTURE AND PERFORMANCE IN EUROPE

## I. Introduction

Ownership structures vary considerably across Europe. This paper aims to quantify these differences by comparing three distinct ownership structures of firms, widely held, de-facto control and legal control. We then relate them to the trend component of share prices. It is based on a new and unique data set of uniform ownership data for the largest 100 firms in the five major European economies. To measure performance, we employ a filtering technique that is commonly used in macro-economics to decompose GDP data into a trend and cyclical component. For the first time, we apply this technique to isolate the long term share price trend from other effects. We take this trend as a good indirect indicator of the quality of governance. We observe significant performance differences between the various ownership categories and show that these ownership structures are not consistent with value maximisation principles. Our findings are in contradiction to similar research in the US. The paper is organised as follows: we briefly review the literature on corporate governance, ownership and performance in section 2. Section 3 outlines data and methodology while section 4 depicts our results. Section 5 discusses the findings and draws preliminary conclusions.

## II. Literature Review

The underlying problems of corporate governance in a world of incomplete contracts are well documented. The separation of ownership and control of the private corporation gives rise to a principal-agent problem, which can result in the sub-optimal use of capital (Stiglitz and Edlin, 1995 and Shleifer and Vishny 1998). In an environment of highly dispersed ownership, the individual shareholder has little or no incentive to monitor management. As monitoring is a costly procedure, the marginal cost of monitoring often exceeds the marginal benefits of

improved performance. Monitoring becomes a public good, as every shareholder benefits from the monitoring activities of others (Stiglitz, 1982).

As early as 1932, Berle and Means pointed out the fundamental principal-agent conflict in the United States.[i] There, firms had transformed themselves from privately owned and entrepreneurial driven entities into public companies, to reap the benefits of scale and scope available in the domestic market of the time (Chandler, 1990). Over the last twenty years, Europe has also witnessed fundamental changes in how ownership is organised. Large scale privatisation programmes significantly reduced government control and moved enterprises into the private sector, and many previously privately controlled firms raised equity capital on public markets for the first time.[ii,] The issues of efficient ownership structures and corporate governance are particularly salient for the European Union, as a vastly greater percentage of GDP flows through publicly listed companies that are nevertheless controlled by a small number of shareholders or shareholder coalitions.

Corporate Governance is concerned with solving the agency problem that Berle and Means identified, by designing mechanisms that assure providers of capital security of return on their investment (Shleifer and Vishny, 1997). It has developed mechanisms to mitigate the agency problem. The available measures can be divided into internal control mechanisms within the firm, and external control mechanisms outside the firm.[iii] The efficiency of these mechanisms varies depending on the prevailing economic and political systems, the dominant industrial sectors and labour relations in each country.

It is argued that deficiencies in national Corporate Governance structures are mitigated by higher concentrations of ownership. For example, La Porta *et al.* (1996, 1997 and 1998) argue that ownership concentration and institutional differences are a response to differing degrees of legal protection of minority shareholders across countries. Roe (2003), Pagano and Lombardo (1999) and Pagano and Volpin (2001) argue that political determinants primarily explain differences in ownership concentration. However, it is clear that significant differences exist in ownership structures within the European Union (Barca and Becht, 2001 and Faccio and Lang, 2002).

In this paper, we are interested in establishing what impact ownership has on the performance of the firm relative to its peer group with alternative ownership arrangements. In addition, our

consistent data across countries allows us to make comparisons about the efficiency of differing ownership arrangements.

The impact of ownership on firm performance is twofold. On the one hand, concentrated ownership can provide for better control of management, as size of ownership stake and the incentive to monitor are positively correlated. In turn, this should improve firm performance and equally benefit minority shareholders. On the other hand, it can come with costs for minority shareholders as the controlling owners might try to expropriate from them. This is one of a number of private control benefits enjoyed by large block holders at the expense of firm value (Jensen and Meckling, 1976; Grossman and Hart, 1988). A number of surveys have attempted to measure these at the country level. For example, Nenova (2000) documents differing levels of private control benefits across a large cross-section of countries reflected in premiums paid for voting shares.[iv] Dyck and Zingales (2004) document similar control premia paid in European block trades. Bebchuk (1999) argues that it is rational for block holders to grab these private control benefits before managers do..

The existing literature is split concerning the effect of ownership on performance. Bebchuk and Roe (1999) and Roe (2003) argue that what, at face value, appear to be inefficient ownership structures (whether dispersed or concentrated), are in fact efficient in the context of their institutional environment. Coffee (1999, p. 3) argues that the current ownership arrangements are more a "product of a path-dependent history than the 'neutral' result of an inevitable evolution toward greater efficiency". If this second proposition is correct, then the predominant ownership structure might not necessarily be the best performing one.
This suspicion is confirmed by Thomsen *et al.* (2003) who pointed out that blockholders might destroy firm value when studying firms in the largest continental European countries. Nevertheless, all the above evidence clearly implies that ownership structures matter for firm performance, whether positively or negatively.

Acemoglu (1999b, 2004) has pointed out that the long-run equilibrium of economic institutions is often sub-optimal. Reform of institutional arrangements, within which we include corporate control and governance arrangements, might imply a possible loss to groups that currently hold power. It is argued that as these groups cannot be credibly compensated ex-post for their loss of power, they have an incentive to block change. The implication is that ownership structures might not adjust perfectly to changes in economic

conditions or the needs of the firm. This view, which is in line with our findings in section IV, would predict that we see inefficient ownership structures persist over time. As Zingales and Rajan (2003, p. 2) state, "financial systems do not …. emerge simply as a result of their superiority in a particular environment. The power of vested interest distorts the process of evolution."

These findings are in clear contradiction to Demsetz and Lehn (1985) and Demsetz and Villalonga (2001). They argue that an optimal ownership structure is achieved through private contracting between shareholders and management based on the value maximisation principle. The financing costs of concentrated ownership increases with firm size because families, and other controlling investors, cannot diversify their portfolio. Therefore, a firm has a natural incentive to move to a more diffuse ownership structure, and we should observe an optimal ownership structure where the benefits of control and financing are at an equilibrium. Consequently, they argue that no relation between the two variables can be detectable, and empirically found no relationship between ownership structure and performance for a sample of US firms between 1976 and 1980.

Therefore, in this study we set out to examine the available evidence about the association between ownership and performance, and to evaluate the stated hypothesis put forward by Roe and Coffee as well as Demsetz.

## III.   Data Set and Methodology

**Data**

We have collected ownership data for all closely held shares for the top 110 public companies in Germany, UK, France, Italy and Spain, from both Bloomberg and Factset, and cross-verified our data sample. Ownership data is inherently unreliable and the use of a single data source (as in the case for most papers in the field) limits the generalisability of the results. In cases where both sources showed identical results, we assumed that the data was correct. In the case of discrepancies, we consulted other sources including regulatory listings, public statements, news sources, and industry and city analysts.[v] The result is a unique new data set of consistent and reliable ownership data across the five countries under investigation. We removed those firms from the sample for which we could not produce reliable ownership data. In addition, we excluded investment trusts, asset managers, insurance companies, real estate investment companies, listed foreign subsidiaries and companies with free float of less than 10% of share capital. Our sample holds 97 firms for Germany, 94 for Spain, 93 for France, 97 for Italy and 100 for the UK.

Share price data – our performance measure – was sourced from Factset and DataStream on a quarterly base. Both ownership and performance data was collected in October 2002. Ownership data describes the ownership status at that point in time, and performance data covers a period of 10 years prior to that date. In addition, and unlike the previous literature, we are focusing on shareholder groups that have a substantial interest in the firm and can, individually and together, exert varying degrees of control. We call this group of shares "closely held". We take both the largest single shareholder and the top three shareholders, and see if individually, and combined, they can exert a certain degree of control over the firm.

We believe that the control benefits of small, but substantial, shareholder groups can easily outweigh the co-ordination costs of such a combination. A pure research focus on the largest shareholder of a company is, from our point of view, not appropriate in isolation, and often not in line with reality. We are trying to overcome the limitations of the literature by moving beyond this and focusing, where applicable, on shareholder groups.

**Methodology**

In this paper, we are analysing the relationship between control and performance. To undertake this analysis, we group 'control' in three distinct ownership categories: Legal Control (LC), De-Facto Control (DC) and Widely Held (WH) firms. Owners hold Legal Control of firms, where either one shareholder or a shareholder group controls over 50% of the votes at the annual general meeting.[vi] We defined De Facto Control for each country in line with the national mandatory bid threshold. This is the level of ownership of voting shares at which local regulators have concluded a shareholder will have significant influence on the outcome of decisions at the annual meeting. A shareholder who breaches the threshold is required to make a mandatory tender offer for all outstanding shares.

| | |
|---|---|
| **France** | **33.3%** |
| **Italy** | **30%** |
| **Germany** | **30%** |
| **Spain**[vii] | **25%** |
| **UK** | **30%** |

Table 1: Mandatory Bid Thresholds in Europe

Widely Held is the remaining ownership category, where no single shareholder or tied group of shareholders own a percentage of voting share capital above the mandatory bid threshold.

The analysis of the performance effects of ownership relies on a market-based measure. Such measurement is preferable to accounting-based measure, as it allows the comparison of European data without regard for different national accounting conventions. Share prices encompass the future expectations of investors, giving us a broader measure of performance.

A number of recent studies have questioned the empirical measurement of the effectiveness of corporate governance. Börsch-Supan and Köke (2000, p. 1) have pointed out that "empirical studies on corporate governance have more than the usual share of econometric problems". These authors and Ødegaard and Bøhran (2003) centre their criticism around the high data requirements and data availability of these studies that aim to analyse, for example,

mechanisms of governance and control, including the board structure, management ownership, and compensation.

From our point of view, corporate governance is a dynamic system of interdependent control mechanisms. This means that shortcomings in one control category might be over-compensated by alternative mechanisms. However, it is also possible that the dominance of one corporate governance mechanism means the suppression of another one. For example, strong owners might try to weaken alternative control mechanisms to gain almost perfect control over the firm. Although, the weakness in corporate governance regulation in some countries might duly be compensated by higher ownership concentration.

Moreover, a weakness in the performance of a firm may lead to changes in the governance arrangements. In consequence, exogenous or independent variables are perceived to be endogenous, and any econometric work might suffer from reverse causality., However, we found when analysing selected cases in great depth and over long periods of time that European ownership structures seem to be very stable per se. More importantly though, even if significant changes to ownership occur, firms hardly ever seem to move out of their respective ownership categories. In summary, endogeneity seems to be far less important in a European context and particularly in our setup than previously thought.

Our aim was to develop a methodology that allows us to precisely measure the long term performance of the firm, and so indirectly that of management and governance, while eliminating firm specific business cycles and many other external factors that might temporarily effect business performance, and for which only limited amounts of information and structured data is available.

To measure performance, we employ a filtering technique that is commonly used in macro-economics to decompose GDP data into a trend and cyclical component. For the first time, we apply this technique to share price data to isolate the long term share price trend from other effects. To estimate the firm level long term trend growth in Europe, we employ a low-frequency Hodrick-Prescott (HP) filter to isolate the trend from cyclical fluctuations. We take this trend as a good indirect indicator of the quality of governance..

We group all firms in three ownership categories, and calculate average quarterly returns of the long term trend performance of each firm per ownership group. This allows us to draw inferences about the comparative long-term performance of the various groups. We base our analysis on the log of quarterly share prices Then we isolate the trend component using the HP filter (Hodrick and Prescott, 1980; Stock and Watson, 1998 and 2003) and calculate the quarterly growth rate as $\ln(p_t/p_{t-1})$. In principle, a low frequency filter removes all cyclical components above a certain frequency. We believe that by employing this methodology we can estimate the long term growth of the firm – in itself a good indicator of the quality of the governance arrangements - while removing all cyclical components.

Prescott describes the HP filter as an approximation of the more precise band-pass filter. The HP filter usually eliminates all frequencies lower than eight years. One disadvantage of the HP filter is that it captures only a subset of the time series variation, leaving a certain cyclical component with the trend. In addition, this effect is amplified by the fact that our available data set is limited to ten years while eliminating trend cycles below eight years, further underestimating the cyclical component at both ends of the time series. Although this limits the use of the absolute result of the trend approximation to a certain degree, we are, however, primarily interested in the relative performance of the three ownership categories. As the firm specific cycles correlate well with the overall business cycle, this should cancel out the negative aspects described above (King and Rebelo, 1993).

We calculated our results for both a quarterly-rebalanced portfolio as reported in the rest of this paper and for a stable sample of firms. Using a quarterly-rebalanced portfolio has the advantage of including all the information that is available in the sample by including all firms that have entered the market over the last 10 years. A stable sample excludes those firms. As the results from the two samples are almost identical, we only report the results for the rebalanced portfolio.

We report our results in form of the cumulative distribution function per ownership category and test for significant differences in relation to other ownership categories. The results should be read in the form that a certain percentage of all quarterly returns are below a given return threshold. Therefore, the better performing a group, the further it will be on the right hand side of the chart. We find first-order stochastic dominance, and therefore strictly better performance, for many of our ownership groups. We control for risk by using an adjusted ex-

post Sharpe ratio. The ratio expresses the quarterly return per unit of variability of all returns of this ownership category.

In summary, we isolate the component of long term growth in the share price that represents the effective management of the firm. In turn, we would argue that this component is driven by a good governance structure which effectively monitors and incentivises managers to maximise the value of the firm in the interests of all shareholders, and minimises, as far as possible, principle agent issues.

## IV.    Ownership and Performance

The following section discusses the differences in performance of the various ownership categories (legal control, de-facto control and widely held ownership) at the country level.

**France:** In France, the dominant form of ownership is legal control, while the best performing category is de-facto control, with an ownership block between 33.3% and 50% of the voting shares. The performance differences between de facto control and widely held firms as well as firms under legal control are significant at the 1% level for both the risk-adjusted and un-adjusted returns[viii]. This indicates that in France those firms that are controlled by minority shareholders achieve genuinely better returns without accepting a higher degree of risk. After adjusting for risk, widely held firms were the worst performing ownership group, while before risk-adjustment widely-held firms performed as well as firms under legal control.

| AQR | WH | LC | DC | WH |
|---|---|---|---|---|
| **Mean** | **2.46%** | **2.47%** | **4.35%** | |
| **Variance** | 0.00011 | 0.00012 | 0.00026 | |
| **N** | 34 | 48 | 13 | |
| t | -0.078 | | | |
| t | | -5.970*** | | |
| t | | | -6.156*** | |

| Sharpe | WH | LC | DC | WH |
|---|---|---|---|---|
| **Mean** | **0.027** | **0.033** | **0.064** | |
| **Variance** | 0.00013 | 0.00021 | 0.00057 | |
| **N** | 34 | 48 | 13 | |
| t | -1.799* | | | |
| t | | -7.123*** | | |
| t | | | -8.771*** | |

WH: Widely Held; LC: Legal Control; DC: De-facto Control

Table 2 a,b:  Average quarterly returns (AQR, left) and risk adjusted average quarterly returns (right) per ownership group in France
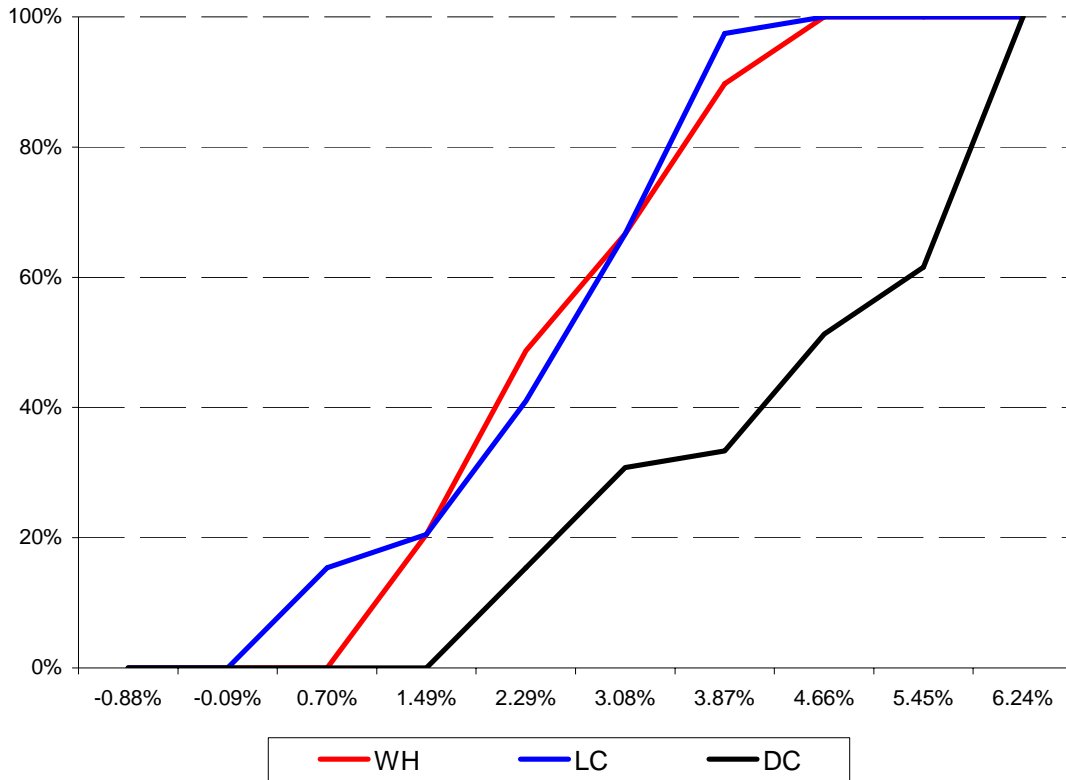
Figure 1: Control Structure and Performance in France

Interestingly, companies with legal control only marginally outperform widely held ones, suggesting that investors in France are essentially indifferent between the two categories. In turn, this might point to a failure to establish an effective corporate governance system that protects minority investors interests from dominant shareholders where there is legal control, and from senior managers where the firm is widely held. La Porta *et al.* (1998), point out France has a civil law system, which in their study is synonymous with low minority investor protection. As stated, while minority investors look to large block holders to monitor management and stem expropriation, they run the risk of expropriation and exploitation of private control benefits by these block holders. Given the alternative ownership structures of the French system, minority investors seem to want block holders to monitor management, but within the de facto control structure which collectively gives them a veto on major strategic decisions. Therefore, based on its relative out-performance, the de facto control structure provides the most effective governance system within the French institutional context. However, the fact that legal control is the largest ownership category with over 50% of the sample, indicates that French ownership structures are inefficient.

**Germany:** In Germany the dominant form of ownership is also legal control. However, the best performing companies are widely held. Companies under de facto control are the next best performing group, and legal control the worst performing. The performance effect is statistically significant for all groups at the 1% level, except between the widely held and de-facto control group. After adjusting for risk, widely held firms remain the best performing group, followed again by the de-facto control group. The performance differences remain significant between the widely held and legal control group, and become significant between the de-facto and legal control group at the 1% level. Put differently, the legal control group significantly underperforms all other ownership categories.

| AQR | WH | LC | DC | WH |
|---|---|---|---|---|
| Mean | 2.73% | 1.25% | 1.70% | |
| Variance | 0.00036 | 0.00029 | 0.00024 | |
| N | 26 | 53 | 26 | |
| t | 3.606*** | | | |
| t | | -1.202 | | |
| t | | | 2.613** | |

| Sharpe | WH | LC | DC | WH |
|---|---|---|---|---|
| Mean | 0.040 | 0.014 | 0.031 | |
| Variance | 0.00077 | 0.00034 | 0.00081 | |
| N | 26 | 53 | 26 | |
| t | 4.896*** | | | |
| t | | -3.204*** | | |
| t | | | 1.363 | |

WH: Widely Held; LC: Legal Control; DC: De-facto Control

Table 3 a,b: Average quarterly returns (AQR, left) and risk adjusted average quarterly returns (right) per ownership group in Germany
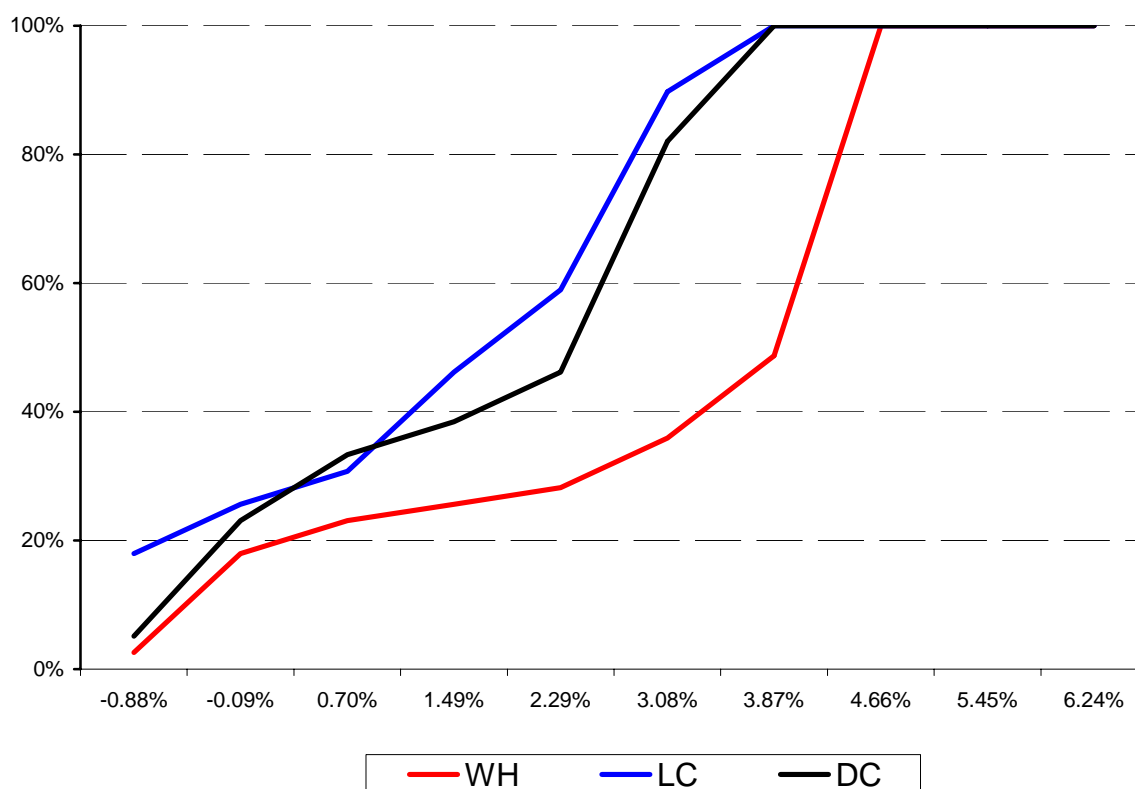


Figure 2: Control Structure and Performance in Germany

This would suggest there is better protection for minority shareholders in Germany relative to France, and therefore less need for blockholders to monitor management to protect their interests. Private control benefits in Germany are less than in France. This is in line with the findings of Nenova (2000), who measures private control benefits across countries, finding them equal to 28% of market capitalisation in France, which she terms "alarmingly high" (p. 4) versus 9.5% in Germany and 4.5% in common law jurisdictions generally.[ix] However, they are still substantial enough to incentivise dominant shareholders to maintain control in over 50% of the German companies in the sample. Ultimately, this has the effect of driving the relative underperformance of firms controlled by block holders, and is a strong indication that German ownership structures are inefficient.

**Spain:** In Spain, the dominant form of ownership is legal control, but again the best performing ownership structure is the widely held category. The performance differences between widely-held firms and firms with both legal and de-facto control are significant at the 1% level. After adjusting for risk, the de-facto control group is the best performing group, however the only significant relationship (at the 1% level) is the out-performance of the widely held over the legal control group.

| AQR | *WH* | *LC* | *DC* | *WH* |
|---|---|---|---|---|
| **Mean** | **4.05%** | **2.65%** | **2.46%** | |
| **Variance** | 0.00029 | 0.00042 | 0.00046 | |
| **N** | 28 | 45 | 19 | |
| **t** | 3.278*** | | | |
| **t** | | 0.402 | | |
| **t** | | | 3.634*** | |

| Sharpe | *WH* | *LC* | *DC* | *WH* |
|---|---|---|---|---|
| **Mean** | **0.038** | **0.027** | **0.045** | |
| **Variance** | 0.00027 | 0.00028 | 0.00153 | |
| **N** | 28 | 45 | 19 | |
| **t** | 2.984*** | | | |
| **t** | | -1.020 | | |
| **t** | | | 0.063 | |

WH: Widely Held; LC: Legal Control; DC: De-facto Control

Table 4 a,b:  Average quarterly returns (AQR, left) and risk adjusted average quarterly returns (right) per ownership group in Spain
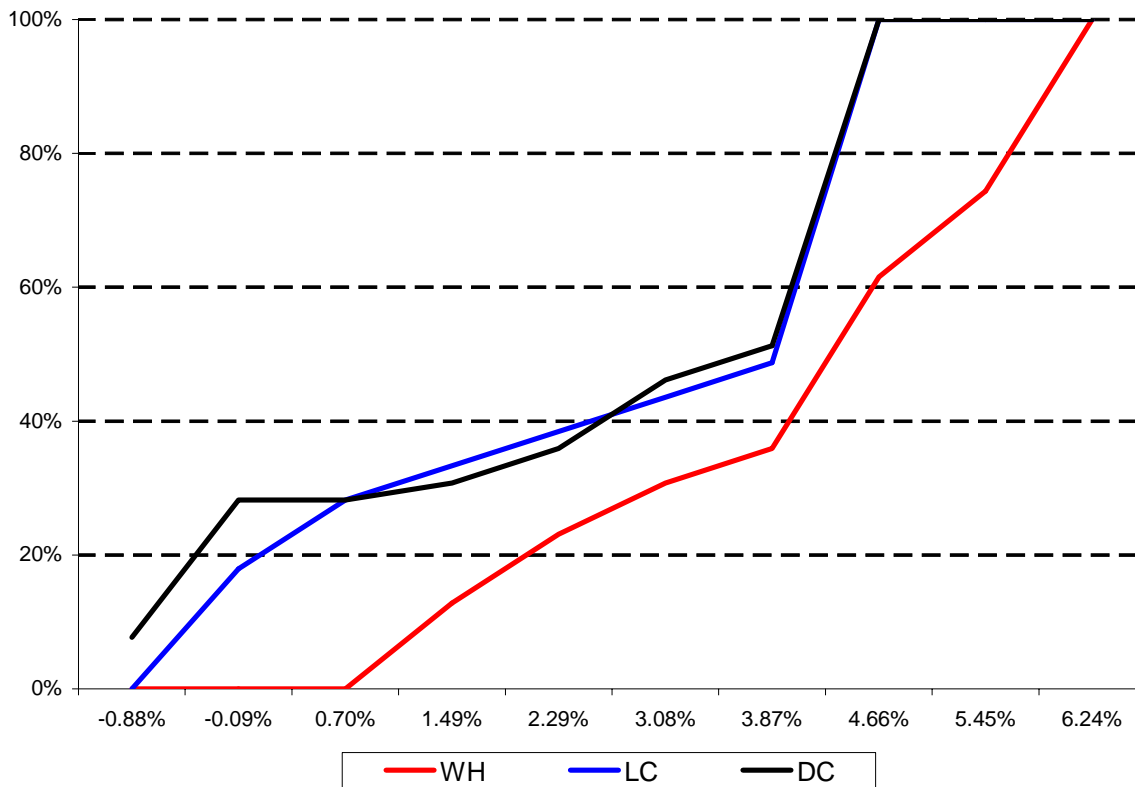
Figure 3: Control Structure and Performance in Spain

Therefore, based on its relative out-performance, the widely held control and de-facto control structures seem to provide the most effective governance system within the Spanish institutional context. However, the fact that legal control is the largest ownership category with almost 50% of the sample indicates also for Spain that the pre-dominate ownership structure is inefficient.[x]

**United Kingdom:** In the UK, widely held firms predominate, providing investors with little choice in terms of control structure. Only 4% of firms in the FTSE 100 fall under the de facto control heading, and 3% under legal control.

This finding is in line with La Porta *et al.*(1998) and Nenova (2000) that common law systems provide stronger protection of investor rights, and therefore might act as a driver of widely held corporate structures. A deep and efficient capital market and UK listing rules which actively discourage block-holdings of above 30% are just two out of many other explanations that can be put forward to explain the strong dominance of the widely-held

ownership group. Undoubtedly, investors seem to be confident that the information provided by the firms and the corporate governance mechanisms are sufficient to monitor and discipline management and feel that they do not have to rely on block-holders to take on this function. In addition, evidence is available to support the notion that block-holders cannot exploit private control benefits in the UK, making the holding of large blocks less interesting. Nenova (2000), for example, finds that private control benefits in the UK equal to only about 9.5% of the market capitalisations of the firms concerned. Dyck and Zingales (2004) survey finds a substantially lower control premium of 2%.[xi] However, given the low number of firms with alternative ownership arrangements, we cannot draw any conclusions about the relative performance of the three ownership categories[xii].

| UK | WH | LC | DC | | Sharpe | WH | LC | DC |
|---|---|---|---|---|---|---|---|---|
| Mean | 2.25% | 2.94% | 1.27% | | Mean | 0.030 | 0.122 | 0.033 |
| Variance | 0.00017 | 0.00024 | 0.00006 | | Variance | 0.00031 | 0.00414 | 0.00040 |
| N | 93 | 3 | 4 | | N | 93 | 3 | 4 |

Table 5a,b: Average quarterly returns (AQR, left) and risk adjusted average quarterly returns (right) per ownership group in the UK.

**Italy:** Finally, the Italian data illustrates the out-performance in the Italian equities markets of companies that have a single, legal controlling shareholder or group with a block over 50% of the voting shares. Uniquely in our sample, this group is also the dominant ownership group. However, the sample of companies is heavily biased toward legal control as the dominant ownership structure with 65% of companies falling into it. The De-facto control group is the next best performing control group. Widely held companies are the worst performers for most of the period. Moreover, the widely held sample, 16% of firms, is dominated by banks. These often have a unique ownership and regulatory structure, and are controlled by foundations with special control rights, and cannot be treated as standard public companies (Galbraith, 2002). However, only the performance differences between widely held firms and firms with legal control are statistically significant at the 5% level, limiting somewhat the generalisability of our results. After controlling for risk, the performance differences between those two groups remained significant at the 5% level, the differences between the legal and de-facto control group became significant at the 10% level.

| I | WH | LC | DC | WH | | Sharpe | WH | LC | DC | WH |
|---|---|---|---|---|---|---|---|---|---|---|
| **Mean** | **1.83%** | **2.49%** | **2.28%** | | | **Mean** | **0.022** | **0.023** | **0.020** | |
| **Variance** | 0.00022 | 0.00020 | 0.00037 | | | **Variance** | 0.00032 | 0.00018 | 0.00028 | |
| **N** | 15 | 69 | 18 | | | **N** | 15 | 69 | 18 | |
| **t** | -1.980* | | | | | **t** | -0.357 | | | |
| **t** | | 0.543 | | | | **t** | | 1.006 | | |
| **t** | | | -1.144 | | | **t** | | | 0.554 | |

Table 6a,b: Average quarterly returns (AQR, left) and risk adjusted average quarterly returns (right) per ownership group in Italy.
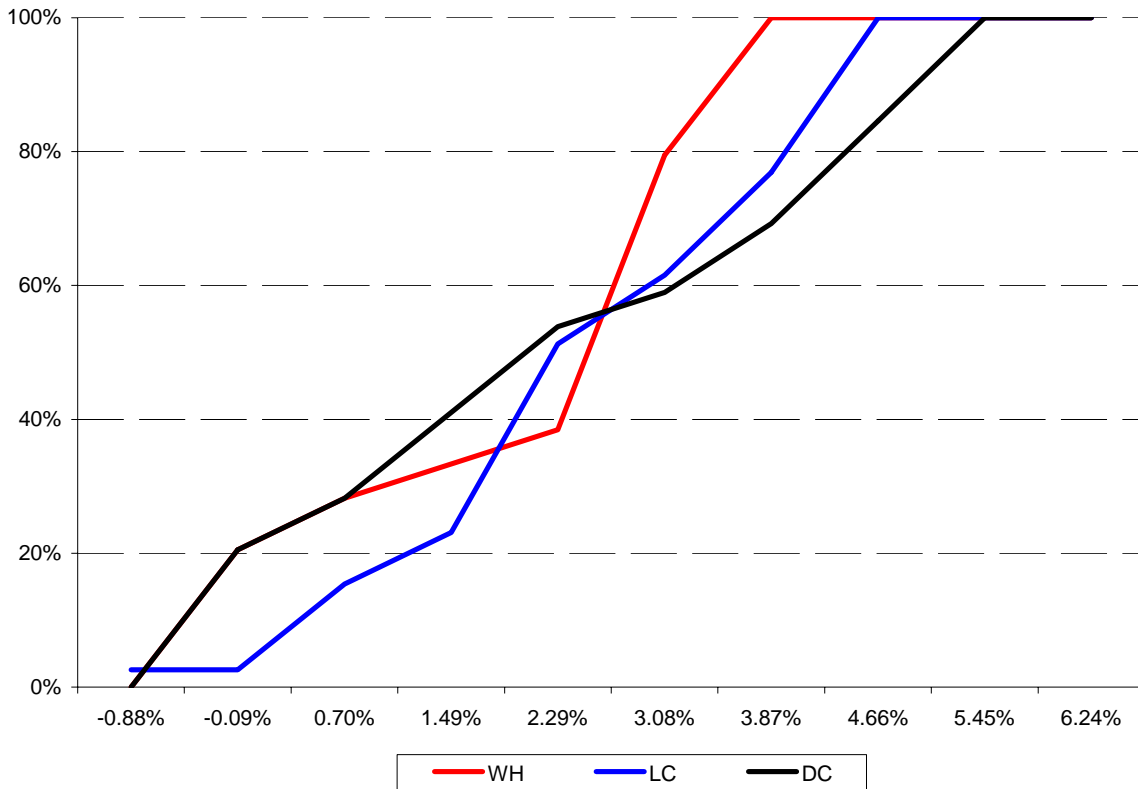


Figure 4: Control Structure and Performance in Italy

Therefore, we are left to conclude that there are no widely held public companies amongst the top one hundred in Italy. In turn, this points to the failure to establish an effective corporate governance system that protects minority investors in line with La Porta *et al.* (1998). While minority investors look to large block holders, in the Italian case families and the state, to monitor management and stem expropriation, they of course run the risk of expropriation and exploitation of private control benefits by these block holders. Nenova (2000) estimates that private control benefits for dominant shareholders in Italy to be approximately 29% of market capitalisation, one of the highest in her survey and again "alarmingly high" (p. 4) in her words, while Dyck and Zingales (2004) place it even higher at 37%.

# V.    Robustness Test

To ensure that our documented results are truly one of ownership and not the effect of other variables like industry, liquidity or the type of owner, we have regressed the average long term performance of each firm against ownership and controlled for industry and country effects, liquidity expressed as a percentage of the free float of all outstanding shares, and type of the largest owner. Due to the above discussed endogeneity issues, it cannot be ruled out that we simply document associations between these two variables. In any case, we show below that firms under legal control significantly underperform widely held firms in Europe. More importantly, we show that our documented performance differences are not due to industry, country or liquidity effects. In addition, the type of owner has no significant impact on performance other than the value destructive effect of state ownership.

| Regressors | Average Quarterly Performance | |
|---|---|---|
| (Constant) | 0.035 | *** |
| | (0.011) | |
| Legal Control | -0.010 | * |
| | (0.006) | |
| De-facto Control | 0.002 | |
| | (0.006) | |
| | | |
| Free Float [%] | -0.012 | |
| | (0.010) | |
| | | |
| Spain | 0.011 | * |
| | (0.006) | |
| Germany | -0.004 | |
| | (0.006) | |
| Italy | 0.005 | |
| | (0.006) | |
| France | 0.007 | |
| | (0.005) | |
| | | |
| Family | 0.001 | |
| | (0.006) | |
| Financial | -0.002 | |
| | (0.006) | |
| Corporate | -0.007 | |
| | (0.006) | |
| State | -0.017 | ** |
| | (0.008) | |
| Misc. | 0.006 | |
| | (0.011) | |

\*\*\*: significant at 1%, \*\*: significant at 5%, \*\*\*:  significant at 10%
Equation also includes 10 industry dummies.
Excluded Variables: UK, Institutional, Widely held.
Standard error in parenthesis.

Table 7:  Effects of ownership on long term firm performance

# VI.    Summary and Discussion

In this paper, we have shown that ownership matters in Europe. In a number of major European economies, the dominant form of ownership is not the most efficient one. Across Continental Europe, legal control by a large shareholder, or coalition of shareholders who control the board, is the dominant ownership category. We documented for Germany and Spain that widely held firms significantly outperform those under legal control. Firms in the United Kingdom are almost exclusively widely held. The predominance of legal control is puzzling as, from a wealth maximisation perspective, the dominant blockholder(s) would benefit from holding a more diversified portfolio of assets. Corporate owners would serve their shareholders better by investing in internal projects with higher pay backs or returning money to shareholders via share buybacks.

The results clearly contradict the findings of Demsetz and Lehn (1985) who argue that ownership arrangements vary in ways that are consistent with value maximisation, and that consequently one should not be able to observe systematic differences between ownership and performance. This is in clear contradiction to our findings, where we have shown that ownership structures in Europe are often inefficient.

In line with similar findings by Acemoglu (2004) on institutions, we would argue that it is difficult to give these dominant owners the ability to participate in the future gains from improved ownership. The introduction of mandatory bid thresholds might act as a further disincentive, as sellers of ownership blocks would have to place these widely in the future, likely forgoing a control premium. Moreover, dominant shareholders may also face significant capital gains tax bills, which act as another hurdle to selling down large ownership stakes. It is also very hard to compensate for the loss of non-pecuniary benefits.[xiii] Consequently, there is little incentive to realign ownership structures in Europe.[xiv]

One possible explanation for the good performance of widely held firms might be fundamental changes in the nature of European capital markets and their governance institutions in the 1990s. Such changes include, but are not limited too, increased liquidity, disclosure requirements, information flows and legal protection of minority shareholders (e.g. introduction of pan-European insider trading regulations).

Encouraging owners to sell down their stakes should help to maximise the value of the firm and the wealth of shareholders. All shareholders would benefit from the re-rating of the stock, as markets clearly prefer simplified control structures (Shinn and Gourevitch, 2002). The literature points out the benefits of increased liquidity, which include a lower cost of capital and risk adjustment of returns, which in turn are reflected in a price premium[xv]. It also allows capital to be efficiently shifted across sectors and geographies (Holmstrom and Kaplan, 2001/2003).

Our argument finds support from Zingales and Rajan (2003), who point out that ownership dispersion and less concentrated control is ultimately a more efficient ownership arrangement, creating greater opportunities across any society and increased political support for market based solutions. Meanwhile, "firms controlled by heirs tend to have lower performance within their industries and lower spending on research and development (p 123)."[xvi] Villalonga and Amit (2004) also find that family firms controlled by heirs destroy value. Zingales and Rajan go as far as to argue that taxation, particularly inheritance tax, should be, "structured so that the rich are encouraged to transfer passive ownership of productive assets (for example, minority stakes in a portfolio of firms), rather than active control, to their children (p. 299)."[xvii]

In conclusion, current European ownership structures are a function of the complex interaction of historic national regulation, tax codes, strength of institutional investors and individual/family wealth preferences, constraints and psychology. The balancing of these interests through the political process at country level has been a prime determinant of current corporate structures. However, as we have demonstrated, these structures are far from efficient for society in aggregate, and Europe would benefit from changing its ownership structures.

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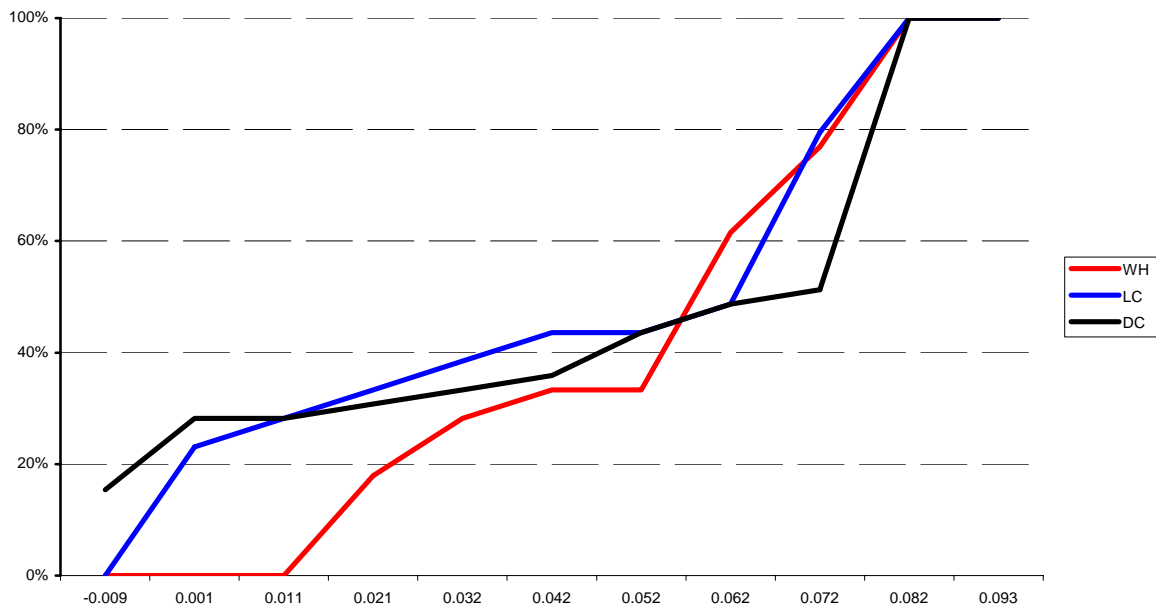
# Appendix I: CDF - Risk Adjusted

**France - Risk Adjusted**



**Germany - Risk Adjusted**
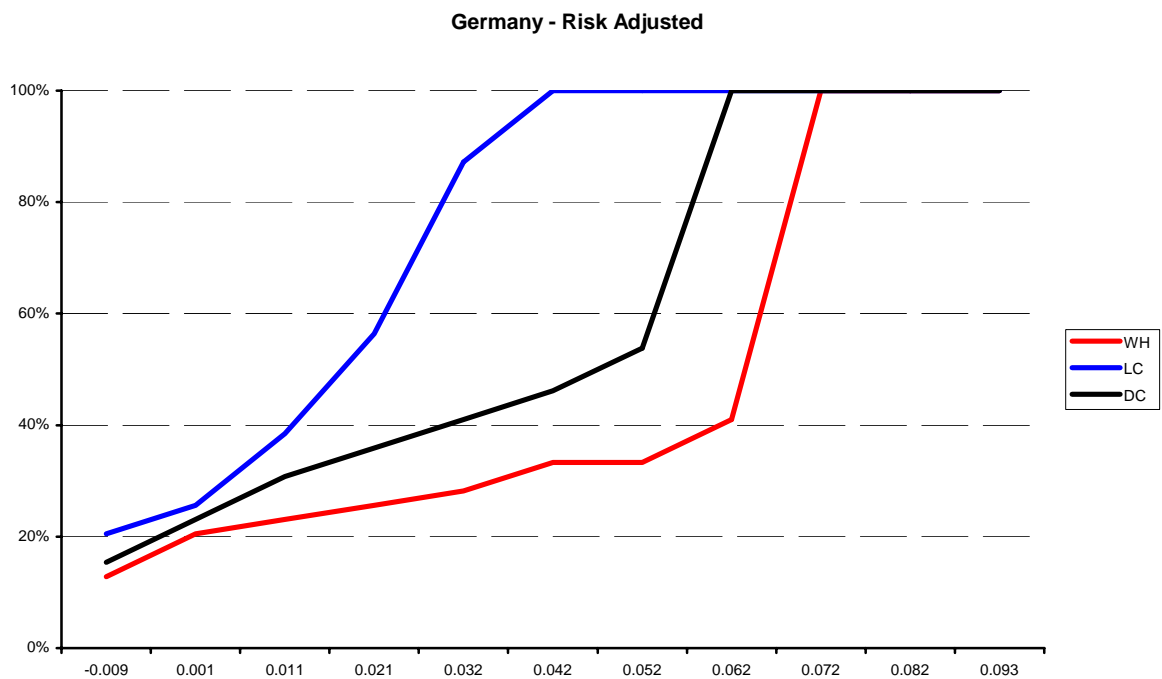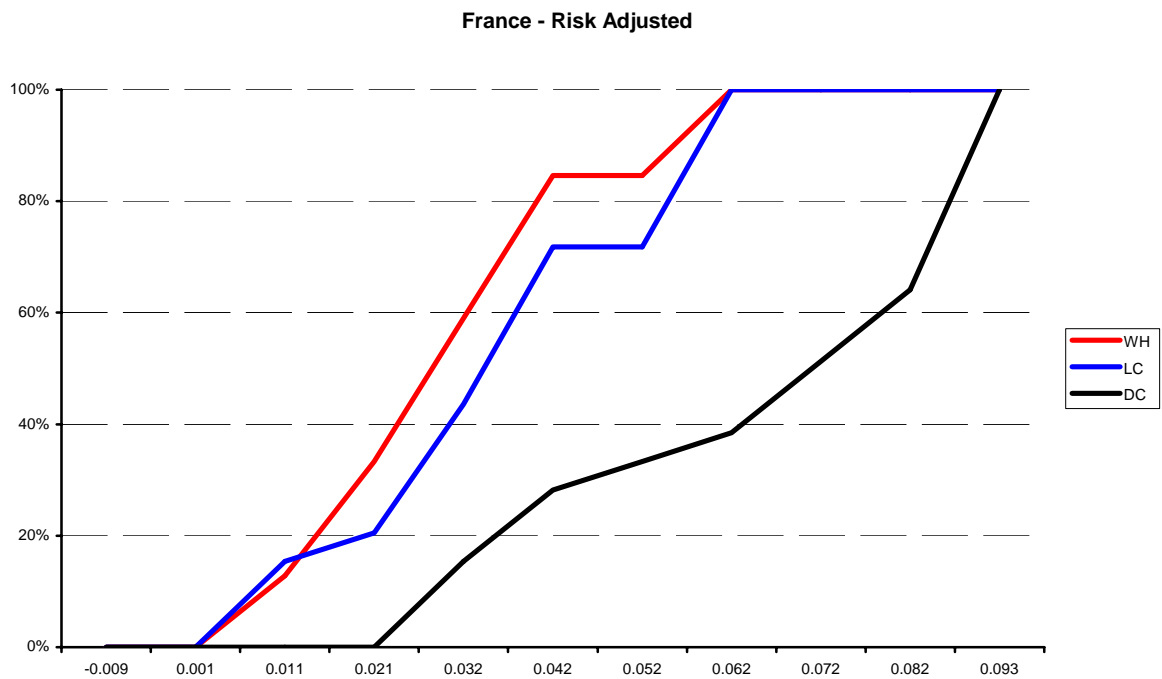
**Italy - Risk-Adjusted**
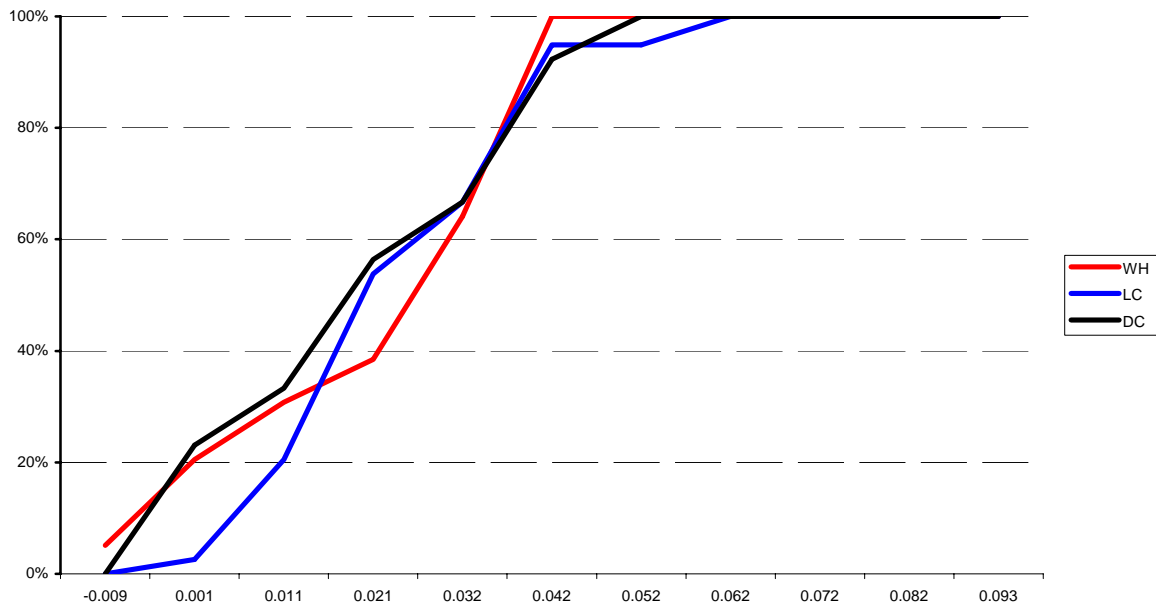


**Spain - Risk Adjusted**

## Appendix II: Industry Distribution per Ownership Category

| Italy | Legal Control | De facto control | Widely held |
|---|---|---|---|
| 1 | 0% | 0% | 0% |
| 2 | 3% | 17% | 0% |
| 3 | 11% | 11% | 0% |
| 4 | 26% | 11% | 7% |
| 5 | 10% | 11% | 7% |
| 6 | 7% | 0% | 0% |
| 7 | 7% | 6% | 0% |
| 8 | 25% | 28% | 87% |
| 9 | 11% | 17% | 0% |
| N | 61 | 18 | 15 |

| Spain | Legal Control | De facto control | Widely held |
|---|---|---|---|
| 1 | 7% | 0% | 11% |
| 2 | 7% | 11% | 15% |
| 3 | 5% | 5% | 0% |
| 4 | 10% | 37% | 11% |
| 5 | 20% | 5% | 15% |
| 6 | 12% | 16% | 7% |
| 7 | 2% | 11% | 4% |
| 8 | 22% | 11% | 26% |
| 9 | 15% | 5% | 11% |
| | 41 | 19 | 27 |

| France | Legal Control | De facto control | Widely held |
|---|---|---|---|
| 1 | 2% | 0% | 3% |
| 2 | 4% | 0% | 18% |
| 3 | 12% | 15% | 21% |
| 4 | 26% | 23% | 9% |
| 5 | 8% | 8% | 9% |
| 6 | 24% | 8% | 12% |
| 7 | 12% | 8% | 9% |
| 8 | 6% | 23% | 9% |
| 9 | 6% | 15% | 12% |
| | 50 | 13 | 34 |

| Germany | Legal Control | De facto control | Widely held |
|---|---|---|---|
| 1 | 0% | 0% | 0% |
| 2 | 2% | 8% | 16% |
| 3 | 16% | 17% | 19% |
| 4 | 31% | 33% | 29% |
| 5 | 3% | 8% | 6% |
| 6 | 17% | 0% | 0% |
| 7 | 5% | 0% | 3% |
| 8 | 12% | 8% | 23% |
| 9 | 14% | 25% | 3% |
| | **58** | **12** | **31** |

| UK | Legal Control | De facto control | Widely held |
|---|---|---|---|
| 1 | 0% | 0% | 3% |
| 2 | 40% | 0% | 11% |
| 3 | 0% | 0% | 8% |
| 4 | 40% | 33% | 23% |
| 5 | 0% | 0% | 2% |
| 6 | 20% | 0% | 16% |
| 7 | 0% | 67% | 9% |
| 8 | 0% | 0% | 12% |
| 9 | 0% | 0% | 16% |
| | **5** | **3** | **92** |

| | |
|---|---|
| **10-19:** | Energy and water supply industries |
| **20-29:** | Extraction of minerals and ores other than fuels; manufacture of metals, mineral products and chemicals |
| **30-39:** | Metal goods, engineering and vehicles industries |
| **40-49:** | Other manufacturing industries |
| **50-59:** | Construction |
| **60-69:** | Distribution, hotels and catering; repairs |
| **70-79:** | Transport and communication |
| **80-89:** | Banking, finance, business services and leasing |
| **90-99:** | Other services |

**ENDNOTES**

[i]   Although Alfred Marshall had contemplated this problem at the end of the 19th Century – (Marshall, 1897).

[ii]  See Yergin and Stanislaw (2002), for details of the intellectual reasoning and battles behind privatisation.

[iii] The internal control mechanisms include, amongst others, the Board of Directors, the remuneration structure of executive and non-executive members, and the degree of ownership concentration. Outside control mechanisms include the market for corporate control, top management turnover and shareholder activism as well as legal protection of investors.

[iv]  These are calculated as the percentage of market capitalisation captured by dominant shareholders beyond their equity stake.

[v]   The European Large Holdings Directive from 1988 (88/627/EEC) requires firms to report an increase of the ownership stake above 10%/20%/33%/50%/75%. Companies have to notify both company and regulator. However, certain countries set lower thresholds in this respect. This data is in itself flawed as companies have to report an increase in their shareholding, but not a decrease (BaFin, 2002).

[vi]  A subcategory of legal control is absolute power. Thresholds for this category differ between countries, but falling within it would allow the shareholder to cast the deciding vote on corporate reorganisations, mergers and equity issuance.

[vii] The Spanish mandatory bid threshold is graduated. If a shareholder acquires, or intends to acquire, above 25% of a company, he must launch a bid for at least 10% of the capital. If he holds a stake of between 25% and 50%, and wishes to increase this by more than 6% in the following 12 months, again he must bid for at least 10% of the capital. To increase a holding above 50%, he must bid for at least 75% of a firm. For research purposes we take 25% as the de facto control threshold.

[viii] Based on Student's t test.

[ix]  Dyck and Zingales (2004) also find a control premium on block trades of approximately 10% in Germany, but substantially lower, at 2% in France (however, this finding is based on 14 positive observations for Germany, but only 2 for France).

[x]   The Nenova survey does not cover Spain because dual share classes are rarely used. Dyck and Zingales (2004) find private control benefits equal to 4% on 4 positive observations.

[xi]  Since Nenova draws her sample from all listed firms in the UK, it is likely that the observations relate to smaller firms outside of the FTSE 100. Our finding based on the top 100 public firms in the UK, is that none have dual classes of shares. Therefore, we would argue that Dyck and Zingales 2% is a better indicator of private control benefits in the UK.

[xii] This is not to deny that there are important UK policy questions relating to the ability of dispersed investors in widely held firms to monitor management and build coalitions to enforce their rights. However, this is a debate about strengthening corporate governance mechanisms, not reforming ownership structures.

[xiii] These are defined by Gilson (2003, p 19) as "psychic benefits of control …social and political access".

[xiv] Particularly since some benefits of diversification can be gained for a dominant shareholder through derivatives transactions, which can be more tax efficient and do not require disclosure.

[xv]  See Demsetz (1968), Stoll and Whaley (1983) and Amihud and Mendelson (1986).

[xvi] Statement based on data from Morck (2000) and Perez-Gonzalez (2002).

[xvii] This would seem to imply that inter-generational asset transfers, perhaps above the national mandatory bid threshold which defines control, should be subject to steeply progressive taxation.