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Signed.  ***.*** ***Date...03/04/ 2012.***

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All errors and deficiencies associated with this work are my own and I will be responsible for them and will not be associated with any individual acknowledged in this work.

DEDICATION

I dedicate this thesis to my wife Immaculate for being the source of my happiness and the reason why I am proud of myself.

ABSTRACT

This thesis sets out the empirical evidence on complex ownership and control using data for UK listed firms adapted from Faccio and Lang (2002) for the period 1996-1999. Using OLS estimation method, the thesis links corporate financial policies and performance with ownership and control.

It reports a negative relationship between control concentration of the largest shareholder and dividend pay- out ratios in companies which separate ownership from control, and a positive relationship between ownership concentration of the largest shareholder and dividend payout ratios, in companies which do not. I show that higher control-rights grant larger shareholders incentives (lower cash-flow rights) and ability (higher control-rights) to extract private benefits, for companies which separate ownership from control.

Supportive evidence emerges of a positive relationship between the largest shareholder's ownership concentration and debt ratio; when ownership concentration of the largest block holder increases, so does the possibility of collusion with management. It is further reported that, family companies employ more debt in their capital structures to prevent dilution of control and have significantly higher debt ratios and lower pay-out ratios than companies controlled by financial institutions. It may be argued that, the absence of strong external monitors makes it easy for family companies to pass control between generations.

Finally, I test the relationship between voting rights of the largest shareholder and firm performance and report a negative relationship, suggesting reduction of corporate values. I demonstrate that firms whose control is shared among two family block holders accumulate more debt and perform worse than firms where the largest family block holder shares control with the second largest financial institution. This suggests that the incentives to collude with the largest shareholder or to monitor the largest shareholder are significantly affected by the type of block holder. It is also shown that firms with control coalition having more than two block holders perform better than those with only two block holders, especially those of the same type.

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ABBREVIATIONS

2SLS – Two Stage Least Square

3SLS- Three Stage Least Square

AGM- Annual General Meeting

CEO- Chief Executive Officer

LSE- London Stock Exchange

MM- Modigliani and Miller hypothesis

MTB- Market –To- Book ratio

NPV- Net Present Value

OLS- Ordinary Least Square

R&D- Research and Development

UK- United Kingdom

US- United States

CHAPTER ONE

1.0 INTRODUCTION

1.1 Research Objectives and Motivations

The general objective of this thesis is to examine the nature of the UK's corporate ownership and control structures and their impact on corporate financial policies and, ultimately, corporate performance. More specifically, the study investigates the effects of the ownership concentration and control structures – issues such as size and identity of multiple large shareholders' controlling group, dual-class equity and pyramidal structures - on the dividend payout policy, capital structure, and performance of UK listed firms.

The distribution of equity holdings, which relates to corporate control power, serves as a control mechanism to optimise the allocation of corporate resources. Therefore, through control power granted to a firm's equity holders, ownership affects productivity by influencing the company's financial policies and thus its valuation (Hill and Snell, 1989). Equity owners use their voting power to limit selfish managerial behaviour patterns, which - according to Berle and Means (1932) - impacts on company performance, especially when ownership is dispersed. Regarding the influence of ownership structure on capital structure and valuation, Shleifer and Vishny (1986) suggest that larger block-holders tend to monitor managers and, as a result, prevent them from making financial decisions that favour their own self-interest, including decisions to adjust the corporate capital structure to suit their personal advancement.

The discussion of ownership structure remains incomplete when it does not consider owners' identities because different firm's owners can have distinct motives and unique interests. It

should be noted that each member of the diverse group of investors has different monitoring competences, different levels of wealth, different preferences about the way he or she wishes to receive investment returns, and different cultural backgrounds, among other distinctions (Thomsen and Pedersen, 2000). This diversity of investors' backgrounds has an impact on their individual goals, which may influence the firm's policy making and ultimately have an impact on the firm's value. For instance, the interest of financial institutional investors may be to realise short-term returns on their investments, so they would choose to sell their shares when the firm suffers a downturn; however, corporations or non-financial institutions may be relatively more focused on long-term relationships and thus make efforts to participate in a restructuring process (Douma *et al.* 2006).

In a principal-agent framework, where the agency conflict is between the controlling block holders and minority shareholders, the role of controlling shareholders may not be that of monitoring corporate managers but rather colluding with them to extract private benefits and expropriate the minority shareholders. The controlling shareholders in such cases use control-enhancing structures which increase their control over firm's assets.

Dividends may play a very crucial role in preventing controlling shareholders from extracting personal benefits and, therefore, reducing possible agency conflicts between minority and majority shareholders. The payment of dividends guarantees a pro-rata distribution to both minority and majority shareholders which prevents the controlling shareholders from controlling corporate wealth. Faccio *et al.* (2001) also suggest that, dividends can be used by the controlling shareholders to reduce the complaints from minority shareholders about possible harming of their interests. From these explanations it is, therefore, feasible to suggest that dividends act as a mechanism to control the selfish behavioural patterns of the controlling shareholders.

The presence of the largest shareholder in a company whose control is sufficient to make corporate decisions may harm the interests of other shareholders. In this situation the controlling shareholders may prefer not to pay dividends; instead they may collude with managers to use the free cash flows to extract personal benefits not shared by other shareholders. Studies which test the relationship between the share ownership of the largest shareholder and dividends pay-out show mixed results. Therefore, it is interesting to find out how this structure influences the corporate dividend policy and ultimately firm performance.

Similarly, debt limits the misappropriation of corporate excess cash flows as previously suggested by Jensen and Meckling (1976) and further developed by Jensen, (1986). However, this role depends on the structure of corporate ownership and control. The conflict between minority and majority shareholders becomes serious if the controlling shareholders accumulate more control by applying control-enhancing mechanisms such as pyramidal structures and dual-class structures. According to Faccio *et al. (2003)*, when the company fails to honour its debt obligations, the net worth of professional managers might not be affected although their reputations and careers may be at risk. For the controlling shareholder of a corporate group, who holds a top corporate managerial position and can borrow through a group affiliate from a group bank, this might not be a concern because, by, say, pyramiding, he can control corporations and banks at the bottom with a low stake and then use money borrowed from the bank to shift resources up to the apex of the pyramid where he has a significant ownership stake.

This may result in affecting shareholders and bank depositors at the bottom of the pyramid. Therefore, debt may be considered to play two roles here: first, to limit diversion of corporate assets by professional managers, as in the US, and yet to facilitate such diversions. In the UK, using the data employed in this study, about 25% of ultimate controlling shareholders are financial institutions such as banks. This suggests that these controlling shareholders may

have control over loans issuance in their institutions and can, therefore, easily facilitate offering huge loans to firms in which they have financial interests. Thus, debt may not be used as monitoring device but rather as an expropriation device.

The presence of the multiple large shareholders in corporations has been suggested by literature to reduce the ability of controlling shareholders to expropriate the interests of minority shareholders. However, a mere presence of multiple large shareholders is argued to have little effect on monitoring controlling shareholders as documented by Maury and Pajuste (2005). According to Maury and Pajuste (2005)'s model on relative size and identity of multiple block holders, higher voting power increases the extraction of private benefits and lower cash-flow rights reduces the incentive effect. According to La Porta *et al.* (1998) and Pagano and Roel (1998), the second largest shareholder, and other shareholders, may have incentives and the ability to monitor the behaviour of the largest shareholder if, and only if, they own a sufficient proportion of the company's shares. The monitoring process may be executed in two forms. The first form is via the effort of large shareholders to form a controlling group to secure the benefit of control as suggested by Bennedsen and Wolfenzon (2000) while the other form involves the cross-monitoring of each other as suggested by Pagano and Roel (1998).

Maury and Pajuste (2005) contend that, a controlling coalition whose members include financial institutions extract less private benefit than the coalition with a family firm because financial institutions are subject to control from regulatory authorities and they may be reluctant to involve into extracting private benefits. Along the same line the study examines the impact of size of the controlling group on firm performance. The study tests the disagreement effect that the more the members of the coalition group the better is the quality

of financial decision passed but the fewer the members, the easier is the expropriation of minority shareholders as advocated by Hoskisson *et al.* (2002).

Furthermore, the study addresses the private benefits extraction hypothesis where some control structures such as pyramiding and dual-class equity structures are used to separate voting rights from cash-flow rights. Given the view that higher debt level relates closely to the possibility of the expropriation of minority shareholders, the relationship between voting rights of the second largest shareholder and debt may either be positive or negative depending on whether the second largest shareholders act as good monitors or, alternatively collude with the largest shareholder to extract personal benefits and ultimately harm the company's value.

As implied in Bennedsen and Wolfenzon (2000), the voting rights of the second largest shareholder are directly related to debt if collusion occurs, while the same is negatively related to debt when the second largest shareholders play properly their monitoring role. It therefore follows that, whether the second largest shareholder colludes with the largest shareholder to extract private benefits or monitor the behaviour of the largest shareholder is an important matter of empirical analysis and is thus one of the purposes of this thesis.

1.2 The Contributions of the Study

Previous studies consistently show that the UK ownership structure is dispersed relative to other European countries. Recent literature shows a change of UK ownership structure from dispersed to concentrate. According to Marchica and Mura (2005), more than 10% of firms in UK are controlled through complex structures and the degree of departure of control-rights from cash-flow rights is reported to be around 11% at a 10% threshold. It is, therefore, hard to doubt that the presence of complex control structures may be being used by controlling shareholders to expropriate the interests of minority shareholders in the UK context more beneficially than engaging in monitoring activity. More recently, Laeven and Levine (2008) report that, almost 75% of the sample of 689 UK listed firms had either multiple large shareholders or a single large shareholder. More specifically, according to Laeven and Levine, 26.7% of firms sampled had no controlling owner, and 42.8% had one controlling owner while 30.5% of the sample represented companies with multiple large shareholders.

Using a sample of 643 UK listed non-financial companies; this study reveals that, ownership in the UK is more complex than considered by most previous ownership studies. The study reveals that, 42% of UK companies have multiple large shareholders and about 40% of the sample firms separate cash flow-rights from control-rights, confirming the presence of controlling block holders. This is contrary to the traditional understanding that UK ownership structure is dispersed. Therefore, this study contributes significantly to the literature by examining the issue of UK corporate ownership and control structures which did not receive appropriate attention in the past in the UK context.

To the best of my knowledge, in previously published work, few studies (if any) have examined the impact of ownership and control structures on both corporate financial policies and performance. The existing studies, which this thesis is aware of, are such as Short *et al.*

(2002) which examines the impact of institutional ownership on dividend policy and Short *et al.* (2002) investigating the influence of managerial ownership and external large shareholders on capital structure.

To prevent corporations from separating control-rights from cash flow-rights, Faccio and Lang (2002) report that, Sweden and Finland set a minimum vote ratio (one-tenth) for their public companies to limit the large departure of cash-flow rights from control-rights. While in some European countries (such as Belgium and Norway) departure from one-share one-vote is prohibited, and in others for instance, Portugal, Spain, France, Germany and Italy the proportion of non-voting shares is capped, in the UK non-voting shares are prohibited but listing rules on the London Stock Exchange allow only limited voting through "preference shares", provided these are given "adequate voting rights.". According to the listing rules, preference shares may have no voting rights at general meetings but adequate voting rights should be attached to preference shares on some resolutions such as, dividends in arrears, reducing share capital and winding-up the firm, and actions affecting their class rights (Faccio and Lang , 2002).

This study argues that, although listing rules require adequate voting rights to be attached to preference shares to maintain lower deviations between control and ownership, the rules do not make clear *what level of voting rights is adequate*. This may create a loophole for managers and controlling shareholders to issue preference shares with lower voting rights enough to enhance their control power. According to DeAngelo and DeAngelo (1985), quoted from Bebchuk *et al.* (2000), "*Calibrating the separation of cash-flow and control-rights in a dual-class equity structure is child's play. A planner can simply attach all voting rights to the fraction of shares that are assigned to the controller, while attaching no voting rights to the remaining shares that are distributed to the public or other shareholders"*.

The study contributes to the literature by reporting that, regardless of the requirement of the LSE listings UK, UK controlling shareholders might have been involved in allocating significantly lower voting rights to preference shares to accumulate more control. However, the study makes the case that, if there were a minimum vote ratio established by law, it would be relatively difficult for controlling shareholders to allocate lower voting rights to preference shares below a recommended level.

This study also contributes to the literature by highlighting the involvement of controlling shareholders of UK companies in employing pyramidal structures to facilitate the controlling shareholders' possibility of accumulating more control. In a sample of 1532 companies across 13 European countries, Faccio and Lang (2002) show that about 21% of UK companies use pyramidal structure, the proportion which is the highest among other 8 countries except for Norway (33.9%), Belgium (25%) and marginally Germany (22.9%).

Using the UK sample of 643 listed companies, this study reports that, about 30% of the sampled firms use pyramidal structures to separate ownership from control. Ultimately, the study contributes to the literature by coming up with the more important findings that the dispersal of control-rights from cash-flow rights in the UK is significantly higher when controlling shareholders employ dual-class equity structures as opposed to pyramidal structures. This finding further suggests that controlling shareholders attach more voting rights to the portion of shares they own (ordinary shares), while attaching fewer voting rights to the remaining shares that are distributed to the public or other shareholders, an activity which Bebchuk *et al.* (2000) refer to as "child's play".

Most previous UK equity ownership studies focus on first-order agency costs, and conflict between managers and shareholders. Unlike previous studies, this study addresses the way of mitigating second-order agency costs, the conflict between majority shareholders and

minority shareholders, a common conflict when corporations have complex ownership and control structures where there are larger block holders who can divert corporate resources to extract personal benefits, currently a common feature in the UK equity market as recently reported by Laeven and Levine (2008) and previously commented by Marchica and Mura (2005). The study empirically confirms several ways of mitigating a second-order agency conflict to reduce this conflict, such as control sharing among the controlling shareholders of different types, the formation of control coalitions with more than two controlling shareholders and favouring the appointment of professional managers in family companies rather than inheriting managerial positions.

Finally, unlike most previous studies which focus on large UK companies, this study uses a sample of a wide range of UK public companies listed in LSE including smaller and medium size companies, allowing generalization of the results of this study.

1.3 Key Research Findings

The first finding of this thesis relates to the influence of higher control concentration of the largest shareholder on dividend payments. The regression results show a negative and significant relationship between control concentration of the largest shareholder and the dividend payout ratio, supporting the contention that the higher control-rights grant the largest shareholders incentives (lower cash-flow rights) and ability (higher control-rights) to extract private benefits by utilizing the corporate excess cash flows in projects of their own interests at the expense of minority shareholders instead of distributing it as dividends. This has a significant effect on shareholders' wealth.

Secondly, this thesis brings forward supportive evidence of a significant positive relationship between the largest block holder's ownership concentration and debt ratio. It is argued that, when ownership concentration of the largest block holder becomes higher, there is a

possibility of colluding with corporate managers. The controlling block holders may influence managerial decisions on employing higher debts to explore some risk projects which are less beneficial to other shareholders. Therefore, one may argue that, the increase in share ownership of the controlling shareholders may lead to an increase in corporate leverage.

When a relationship between voting rights of the largest shareholder and firm performance is examined, it is found that the voting rights negatively relate to firm performance suggesting the reduction of corporate value.

The reduction of corporate value becomes even more severe when the corporate ownership and control are separated. It is shown that about 40% of the sample firms used in this study are reported to have separated cash-flow rights and control-rights. The results show that about 83% of the separation of ownership and control is through either pyramiding (34%) or dual-class shares (49%).

Using regression analysis, this study finds that, the companies whose ownership and control are separated by dual-class equity structures report a more strongly negative relationship between control-ownership wedge and dividends ratio as opposed to those companies whose ownership and control are separated through pyramidal structures. This indicates a greater impact of value reduction through cash flow distribution for companies whose controlling shareholders employ dual-class equity structures than those employing pyramidal structures to enhance control.

This piece of evidence is supported by the level of dispersion of cash flow-rights from control-rights for these groups of companies. It is reported that the deviation between cash flow-rights and control-rights for dual-class closely held companies is significantly greater than for pyramidal companies. Dividend is considered in literature as a corporate governance device which prevents companies from mis-using corporate resources, as suggested in

Jensen's free cash flows hypothesis. The results of this study show that, while companies with a lower control-ownership wedge have more potential to expropriate the interests of minority shareholders, by cutting dividends and retaining more cash for their private benefits, those companies with a higher control-ownership wedge have incentives to pay more dividends because they expect a higher proportion of corporate profits as they have relatively higher cash flow-rights.

When the effect of ownership-control separation was examined on corporate leverage, the results show that, the deviation between control-rights and cash flow-rights of the largest shareholder is positively related to the debt ratio. This finding supports directly the expropriation hypothesis offering an important piece of evidence for the debt-increasing effect.

After testing the relationship between the control-ownership wedge and firms' performance, it is found that the ratio is negatively related to firm performance. This confirms the contention that the deviation of control-rights from cash-flow rights is associated with the negative effect of separation of ownership from control on corporate performance.

Focusing on family-controlled corporations and those controlled by widely-held financial institutions , the study reports that, companies controlled by families have more debt ratios compared to companies controlled by financial institutions. To assure the family control is maintained, the literature e.g. Anderson and Reeb (2003) suggests that, family companies prefer issuing debt rather than equity to discourage inviting in other block holders such as professional and knowledgeable external shareholders like financial institutions to avoid the challenge that might be imposed to the family management. The absence of strong external monitors makes it easy for family companies to pass control and management from one generation to another without any resistance, even if the successors lack sufficient management skills.

This may be suggested to be the reason as to why family companies perform relatively worse than companies whose management positions are not acquired by inheritance as reported in regression results.

The study compares the regression results of performance-ownership relationship between family-managed firms and manager-controlled firms. It is shown that, there is a positive relationship between ownership of the largest shareholder and performance in manager-controlled firms and a negative relationship in family-managed firms. These findings confirm the suspicion that external managers are professionally trained and may use their managerial skills to boost the firm performance as opposed to non-professional managers appointed from within the family, who might lack sufficient managerial skills. This finding is in line with Morck *et al.* (2000) who find that, heir-controlled companies perform poorly due to the lack of sufficient management skills by heirs. The results are also supported by Villalonga and Amit (2006) as evidenced in their own conclusions: "*When family firms are run by descendant-CEOs, minority shareholders in those firms are worse off than they would be exposed to the classic agency conflict with managers"*

To examine the impact of multiple large shareholders on corporate leverage, the composition of the controlling group is assessed. The results show that, companies where both of the first two largest shareholders are family firms use more debts in their capital structures compared to companies whose largest shareholder is a family and the second largest is a financial institution. This finding is consistent with the control incentives of family companies. In an attempt to retain the control, family companies use more debt in their capital structures so as to protect their control from dilution by external shareholders and to block out take-over possibilities.

With the assurance of control, family firms make some corporate decisions which are beneficial to family members and not to the company as a whole. The motivation behind these decisions is to pass ownership and control of the company to the next generations. The presence of the stronger second largest block holder from outside may make it difficult for family companies to pass decisions which are in line with their family succession plans.

Finally, the impact of a controlling group's composition on firm performance is examined and the results show that, companies with only families in their controlling group have lower performance records compared to those companies whose largest shareholder is a family and the second largest a widely-held financial institution. The results support the collusion effect view proposed by Maury and Pajuste (2005) that, the marginal cost of extracting private benefits is lower for the controlling group where both the first and second largest shareholder are family companies compared to coalition groups with the largest shareholder a family company and the second largest a widely-held financial institution.

It is suggested that, the lower the cost of extracting private benefits, the higher is the potential for diverting corporate assets, which impairs the corporate value. This may be considered as a possible reason why companies with only families in their controlling groups are associated with poor firm performance, relative to those companies where the largest share holder is a family and the second largest a widely-held financial institution.

1.4 Structure of the Thesis

This thesis is made up of three related studies preceded by a comprehensive empirical literature review on ownership structure, capital structure and dividend payout policy. The study continues as follows:

Chapter Two: Chapter two summarises a theoretical framework of this thesis. It is in this chapter that all the relevant theories used in the thesis are discussed. The basic theory which is the backbone of this study is the agency theory. On the perspective of agency theory, the study presents thorough discussions of all ownership and control-based theories.

Chapter Three: In this chapter a detailed empirical literature review is presented in three sub-sections. The first sub-section presents a general overview of ownership and control around the world followed by the literature related to ownership and control-performance link. After that the chapter provides a general literature on capital structure followed by ownership-capital structure related literature. In a similar way the last sub-section details the literature on dividend policy linking it with ownership and control.

Chapter Four: Chapter four highlights the methods used in this thesis to collect and analyse data. Sample characteristics and the nature of the data are discussed in this chapter to form the basis of the analysis.

Chapter Five: This chapter presents the first empirical work of this thesis which addresses the influence of ownership and control structures on dividend policy.

Chapter Six: This chapter examines the second empirical work examining the relationship between ownership and control structures and capital structure.

Chapter Seven: In this chapter the thesis presents the ultimate impact of ownership and control structures on firm performance.

Chapter Eight: This is the last chapter which presents important conclusions made in the thesis. The chapter also presents the limitations of the study and suggestions for further studies. Lastly the policy implications of the study are suggested.

CHAPTER TWO

2.0 A THEORETICAL FRAMEWORK

2.1 Agency Theory

Among the many theories which are used in literature to explain the conflict of interest between managers and shareholders, such as property right theory, stewardship theory and transaction cost theory, according to Jensen and Meckling (1976), agency theory is the most popular one and provides a powerful theoretical basis to reduce the agency problem. The theory is based on several assumptions. The first is that managers may maximize their utility at the expense of shareholders' wealth (Jensen and Meckling, 1976). The second is that there is an information asymmetry between managers and shareholders and the third is that there are costly contracts to be written and enforced between principals and agents (Fama and Jensen, 1983).

In their seminal paper on the agency problem, Jensen and Meckling refer to agency relationship as the contractual agreements between one or more person(s) known as the principal(s) and the other person(s) known as agent(s), whereby an agent is engaged by the principal to perform some activity or service on his behalf. This involves delegating some decision-making authority. The best example is in corporations with diffused ownership structure where there is an agency relationship between the shareholders and managers of a corporation. Jensen and Meckling suggest that there is no agency problem at all when the manager holds 100% of the company's equity. In this case, the two parties, owners and manager, are unified and no separation of ownership and control exists. On the other hand, when the ownership of a firm's equity are spread among different outside investors, as in the

case of public companies, the separation of ownership and control results in a divergence of interest between managers and owners.

The essence of the theory is that, as long as reduction of agency costs and inefficiencies in a firm's operations are directly linked with risk-return trade off, these factors are likely to enhance firm performance, provided that the efficiencies are associated with the investments.

2.2 Agency Problem

2.2.1 First- Order Agency Problem (Manager-Shareholders Conflict)

When a company becomes too large to be managed by its owners, either due to lack of management knowledge or lack of time, professional managers have to be employed. These managers are expected to be loyal to the owners and to serve the owners' interests. When investors plan to invest money in a firm's shares, they expect to have a good return from their investment, in terms of dividends and capital gain, according to Fernando (2009). Unfortunately, however, the outcome may not be as expected because managers may behave in their own interests, at the expense of the owners' wealth (Jensen and Meckling 1976)). In these cases there is a need for shareholders protection in order to prevent insiders from betraying shareholders.

According to Fernando, insiders can easily misappropriate investors' profits if there is poor investor protection but such misappropriation may be harder if there is an active law which protects shareholders' rights. The author suggests three ways in which companies' management can divert the wealth of shareholders. Firstly, managers may invest a company's profits into suboptimal projects which favour their own interests but do not maximize the value of the firm. Secondly, managers may sell a company's shares to another company in

which they have stakes at lower than market price. Finally, managers may also shift the company's business opportunities to another company in which they have a personal interest.

Several mechanisms have been suggested to reduce agency problem such as take-over bids, market for corporate control measures, incentive packages and many more. The most popular mechanism, much discussed recently, is the direct involvement of large shareholders in a company's decision making process. According to Stiglitz (1985), monitoring activity is costly and this explains why small owners do not participate in monitoring exercises, since the cost of monitoring may outweigh the associated benefits. Demstez and Lehn (1985), contend that if other mechanisms to align managers' and shareholders' interests are effective then monitoring by shareholders makes little sense economically, but if other mechanisms do not work well, then monitoring by larger shareholders becomes beneficial.

The incentive to pay attention to the control and monitoring of management depends on the amount of money the investor has invested in the shares of a particular company. The smaller the proportion of shares held, the lower the incentive to monitor and vice versa. Therefore, large shareholders may have an economic justification for monitoring and control due to the value of their stake (Shleifer and Vishny, 1997). The authors argue that, it is economical for larger shareholders to carry out monitoring of their management because they have the required skills and expertise to do so. It can also be said that because of their large stake in the company, it makes financial sense for them to carry out monitoring since better performance of the company associated with their monitoring will relatively benefit them more.

The participation of large shareholders may reduce the free-rider problem which can result from poor monitoring of managers who take riskier investment opportunities. According to Shleifer and Vishny, managers may take on these riskier projects, which favour their own interests, due to lack of ownership spirit, benefitting more if the project succeeds but sharing the associated costs if the project fails. The monitoring exercised by larger shareholders on company managers reduces to some extent this problem and the presence of large institutional investors increases the credibility of the company to the outside world.

2.2.2 Second- Order Agency Problem (Majority-Minority Shareholders Conflict)

In the presence of controlling shareholders, the conflict of interest shifts from that between shareholders and management to the conflict between controlling shareholders and minority shareholders. The conflict arises because controlling shareholders are said to use an organisation's resources in a way that harms the wealth of minority shareholders through contractual dealings with the company. The action whereby controlling shareholders shift resources from the focal company to other companies (which they own or in which they have interests) is known as tunnelling. There are different ways in which tunnelling can take place. The first form of tunnelling, according to Djankov *et al.* (2008), refers to controlling shareholders involved in related party transactions. Bae *et al.* (2002) suggest that, related party transactions can be executed through purposely reduced transfer and acquisition prices, benefitting an affiliated firm at the expense of a focal firm.

The second form of tunnelling involves controlling investors to increase their share without asset transferring, through undertaking transactions which harm minority shareholders' interests. Johnson *et al.* (2000), refer to these activities as minority freeze-outs.

Finally, tunnelling can be exercised by controlling shareholders, who are also directors of the company, who set up higher compensations for themselves (Cheung et al. 2005). According to Bebchuk and Hamdani (2009), the role of the market in corporate control is to discipline corporations which divert shareholders' money, but when the corporation has controlling shareholders then the role of the market for corporate control becomes unnecessary.

According to Denis (2001), larger institutional shareholders accumulate benefits which are not enjoyed by minority shareholders and generally take advantage of their voting power at the expense of minority shareholders. This view is also supported by Shleifer and Vishny, (1997), who insist that minority shareholders are expropriated by institutional shareholders since the benefits extracted by institutional shareholders are not equally shared with minority shareholders but costs are equally borne by the two sides. In supporting the self-servicing effect of institutional ownership, Pound (1988), suggests that the close relationship between managers and controlling shareholders may also exacerbate the conflict between minority and majority shareholders.

2.3 Corporate Ownership and Control

2.3.1 Ownership Concentration

The essentials of ownership structure could be defined as follows: specialization of risk bearing and provision of finance and decision-making functions of a company, according to Fama and Jensen (1983). In essence, all these factors are separate, but according to Berle and Means (1932), they are embodied and usually found together in a modern corporation.

It is therefore straightforward to associate a moral hazard, when the cost of risk-taking relates negatively to the degree of control the risk bearers exercise in a risk-taking process. This

potential moral hazard problem can be eliminated or reduced by using debt and equity as control tools, as suggested by Jensen and Meckling (1976).

The utilization of debt and equity produces two possible outcomes, depending on the degree of control exercised by the risk takers (block holders) and the amount of power in the hands of the existing manager. For example, block holders may choose higher debts to invest in suboptimal risky projects which appeal to them personally, because they know that if the risk materialises they will have less to lose. Jensen and Meckling (1976) refer to this action as assets substitution. The use of debts in this way is much more profitable for block holders since, if the project yields returns well above the face value of the debt, shareholders have more to gain in view of their limited liability but have less to lose if the project fails. In case of poor investment, the value of equity (a portion of capital contributed by block holders) is also reduced but this reduction can be more than offset by the gain in equity gained at the expense of debt holders. It therefore follows, according to Friend and Lang, (1988), that level of debt should be higher in firms with a concentrated ownership structure as opposed to in firms with a widely held ownership structure.

According to Jensen (1986), block holders prefer to use debt as a disciplinary mechanism. This is due to the fact that bonding by debt provides minimum opportunity for management to misuse a company's cash flow because debt obligation utilises most of the free cash flow available for misappropriation. This forces firms to pre-commit themselves to generate levels of cash flow large enough to honour their debt obligations (Firth, 1995 and Berger *et al.* 1997).

Since shareholders have diversified their investments, they are ready to take relatively higher risks as their position is well hedged against the occurrence of the firm-specific risk (Fama, 1980).

However, in owner-manager firms, managers are more risk averse and their incentive to undergo asset substitution is highly reduced. This is because more debt attracts bankruptcy which is harmful to managers on a personal level, since they hold considerably larger portions of company shares. In such firms, the level of debt is significantly lower in comparison to other companies (Jensen and Meckling, 1976).

Flow of information from within a firm is a crucial issue as far as ownership structure is concerned. Fama and Jensen (1983), contend that specific information or knowledge, concerning operation of a firm, should be communicated to smaller shareholders who lack direct access to internal information. The authors claim that smaller companies with higher ownership concentration are relatively more effective because this ownership structure leads to a higher degree of association between decision management and control. Likewise, the foregone risk-sharing benefits are less noticeable in smaller firms as opposed to in larger ones since the total shared risk of net cash flows is generally smaller in small firms.

Previous literature suggests that the level of capital resources a company holds and the profits generated from such resources, are the major determinants of the size of such a company. A rise in profitability ultimately increases the share price of that company. Demsetz and Lehn, (1985), suggest that the wealth of the shareholders depends on the market value of the share. The higher the share value, the higher the wealth of shareholders and vice versa. The value of an individual shareholder's wealth depends on the proportion of his/her shareholdings in the total outstanding shares of the company. According to the authors, a higher share price is associated with an increase in risk level, as inferred from finance theory on risk-return trade-

off. This means that rational investors would not dare put their wealth into a single investment with a higher cost of capital, which explains why one would not expect to find concentrated share ownership structure in firms with higher values.

The theoretical relationship between ownership concentration and firm performance may turn out to be positive or negative, depending on various factors. The positive relationship is backed up by "the incentive effect" as suggested by Berle and Means (1932) and supported by Jensen and Meckling (1976). According to these authors, this is the effect whereby, due to a large portion of their money being invested in a company, shareholders have both the incentive and the ability to closely monitor the company's decision making process, ensuring that managers do not seek personal interest at the expense of shareholders' wealth. As a result the firm's performance is improved due to the monitoring role played by large shareholders and in this case ownership structure is used as a corporate governance tool to solve the first order agency problem, namely, the conflict of interest between shareholders and managers.

The group of researchers including Fama and Jensen (1983), Morck *et al.* (1988) and Shleifer and Vishny (1997) who support a negative relationship between ownership concentration and firm performance claim that, as the level of ownership of large shareholders increases, there is a possibility of the entrenchment effect occurring, with large shareholders acting opportunistically to expropriate minority shareholders. In such cases, majority shareholders, using the control they have, might be able to divert company's resources to increase their own wealth at the expense of that of minority shareholders. This leads to the negative performance effect of ownership concentration. This theory suggests that ownership concentration is the source of second order agency problem, which is the conflict of interest between majority shareholders and minority shareholders.

2.3.2 Ownership Identity

Monitoring is one of the key concerns in agency theory since one of the most important solutions to agency problems is monitoring by external shareholders. Previous literature acknowledges that the identity of shareholders matters significantly in reducing agency problems, as argued by Thomsen and Pedersen (2000). They contended that the different groups of share owners have different levels of monitoring competence, different levels of wealth, different preferences about how they receive the return on their investments, different cultures and many other cross-border differences. The authors also argued that the identity of a firm's owners may determine their goals and may also have a big impact on the firm's behaviour. These factors, they believed, ultimately affect the firm's financial decisions and the firm value in particular. Similarly, Cronqvist and Fahlenbrach (2009) support Thomsen and Pedersen's view, that there is considerable block holder heterogeneity with regard to their beliefs, skills and preferences. In their study, the authors report that block holders are categorized into groups such as activists, pension funds, corporations, individuals, private equity firms and mutual funds.

Supporting the view that different owners have different monitoring abilities, Pound (1988), claims that institutional investors are more effective monitors than other shareholders because of the ability and the incentive they have. This view is in accordance with the efficient monitoring hypothesis. However, according to Pound, institutional investors may collude with managers to diverge a company's resources to other companies with which they may have business connections.

However, not all institutional investors have similar monitoring ability. Some institutions are better monitors than others due to incentives attached to their holdings. Both Elyasiania and Jia (2010) and Bhattacharya and Grahams (2009) contend that pressure-resistant institutions

are better monitors than pressure-sensitive institutions. They define pressure-resistant institutions as those without any business connections with their investee companies such as pension funds and mutual funds; while pressure-sensitive institutions are defined as those who have some business links with their investee companies such as insurance companies and banks. The authors, therefore, suggest that the reasons for the difference in monitoring between the two groups of institutions are the potential business ties which pressure-sensitive institutions may have with their investee companies. These ties may impair their monitoring ability due to their fear of losing future business with the company.

On the other hand, pressure-resistant institutions are independent of the management of their investee companies as they have no business link. Consistent with the explanations above, Chen *et al.* (2007) report that, pressure-sensitive institution such as banks and insurance companies, which may have business attachments with the firms they invest in, give more support to management decisions than other types of institutions, in situations involving anti-takeover amendment proposals.

During his study on pension funds, Woidtke (2002) reports a monitoring difference between public and private pension funds. The author believes the reason for this difference is that, unlike private pension funds whose interests are aligned with those of shareholders, public pension funds managers are more motivated by political or social influences.

Unlike pension and mutual funds, Brav *et al.* (2008) contend that hedge funds have the ability to influence company managements and boards of directors due to the incentives they have. According to the authors, hedge funds employ managers who have high incentives and manage large unregulated pools of capital, unlike pension and mutual funds which are more affected by regulations.

2.3.3 Corporate Control Dominance and Contestability

Previous literature suggests that the conflict of interest between majority and minority shareholders can best be solved by the presence of a reasonable number of multiple large shareholders. This is because, unlike a single large controlling shareholder, multiple large shareholders are unlikely to make a decision which is against the firm's interest and in so doing they also protect minority shareholders' interests (Gomes and Novaes, 2005; Laeven and Levine, 2008 and Maury and Pajuste, 2005)**.** Supporting this claim**,** Bennedsen and Wolfenzon (2000) contend that a single block holder does not have sufficient power to control a firm and therefore several block holders need to combine their voting power and agree on the matter in hand before any decision is made.

According to the authors, the number of members forming a controlling group does matter significantly. They state that agreements on some issues, such as policy change, which may attract private benefits to controlling shareholders, become more difficult as members of the coalition increase. This may happen because some members benefit less from the deal than others and therefore may not volunteer to accept a particular decision at the expense of the firm's efficiency, even though it might be in the collective interest of most group members.

It should be apparent that the corporate control structure is determined by large block holders' size of the voting power. According to Leech and Leahy (1991), the size of voting power of large block holders exceeding 50% might dictate the control of the firm even if the remaining block holders might have a possibility of exerting monitoring control .However, attaining a full control is very rare especially for countries such as UK in which dispersed ownership structure dominate. This fact may be supported by the requirement of the UK

Takeover Code that owners with at least 30% of shares should make a takeover offer of the remaining equity.

In a situation where ownership is dispersed and multiple block holders are common there exists a struggle among block holders to accumulate votes from other shareholders so as to attain a majority vote to acquire control over the strategy and decision-making of the companies (Bennedsen and Wolfenzon, 2000; Bloch and Hege, 2001).Different control contestability models are suggested in the literature. These models are as follows;

The first model assumes that the first largest block holder is the firm's ultimate controller. According Pagano and Roell (1998) the model suggests the possible way in which multiple block holders monitor the controlling shareholder .The second largest block holder might be a considerably capable candidate to contest for the control dominance exerted by the largest block holder.

According to Gomes and Novaes (2005), for control to be shared between different shareholders successfully, the size of their holdings should not vary significantly and the shareholders should preferably be of a similar type. Supporting this view, Maury and Pajuste (2005), go further and suggest that a controlling group or coalition, whose members include financial institutions, extract less private benefit than a coalition with a family firm because financial institutions are subject to control from regulatory authorities and so they may be reluctant to become involved in extracting private benefits, for fear of being easily detected. Therefore, in order to prevent the corporate value reduction, the controlling group formation should include different types of block holders.

It is arguable that the second largest block holder might be motivated by the shared control benefits and the cash flow incentives. It is also possible for a group of block holders to contest the control power of the largest shareholder rather than only the second largest

shareholder as suggested by Pagano and Roell (1998) that all or some block holders form a group to monitor a controlling large block holder. According to the authors, the monitoring costs are borne by all block holders. This encourages the monitoring of controllers as the costs are shared among all block holders.

The second model, suggested by Bloch and Hedge (2001), assumes contestability within a coalition presenting a coalition of two large block holders with difference in the capacity to define corporate strategy, monitor the manager and competing for acquiring the votes of minority block holders to attain control. It is considered that, the winning block holder should define firm's strategies and both parties fully involve in a monitoring role and bear the monitoring costs. The authors suggest that the battle for others' vote encourages them to reduce their private benefits and this might boost shareholders' wealth.

3.3.4 Separation of Ownership and Control

The conflict of interest between controlling shareholders and minority shareholders is more pronounced in majority controlled firms than in firms with dispersed ownership (Gugler and Yurtoglu, 2003). According to the authors, majority control allows the largest shareholder to use her own discretion to undergo key corporate financial decisions such as dividend payout decision.

A discrepancy between cash flow rights and control rights of the controlling shareholder opens up the incentive and the ability to increase corporate value reduction potentials. The possible effects of this deviation from one- share one -vote convention is therefore negative although there may as well be a counter effect if rational investors predict expropriation and demand higher contribution in terms of dividend (Gugler and Yurtoglu , 2003).

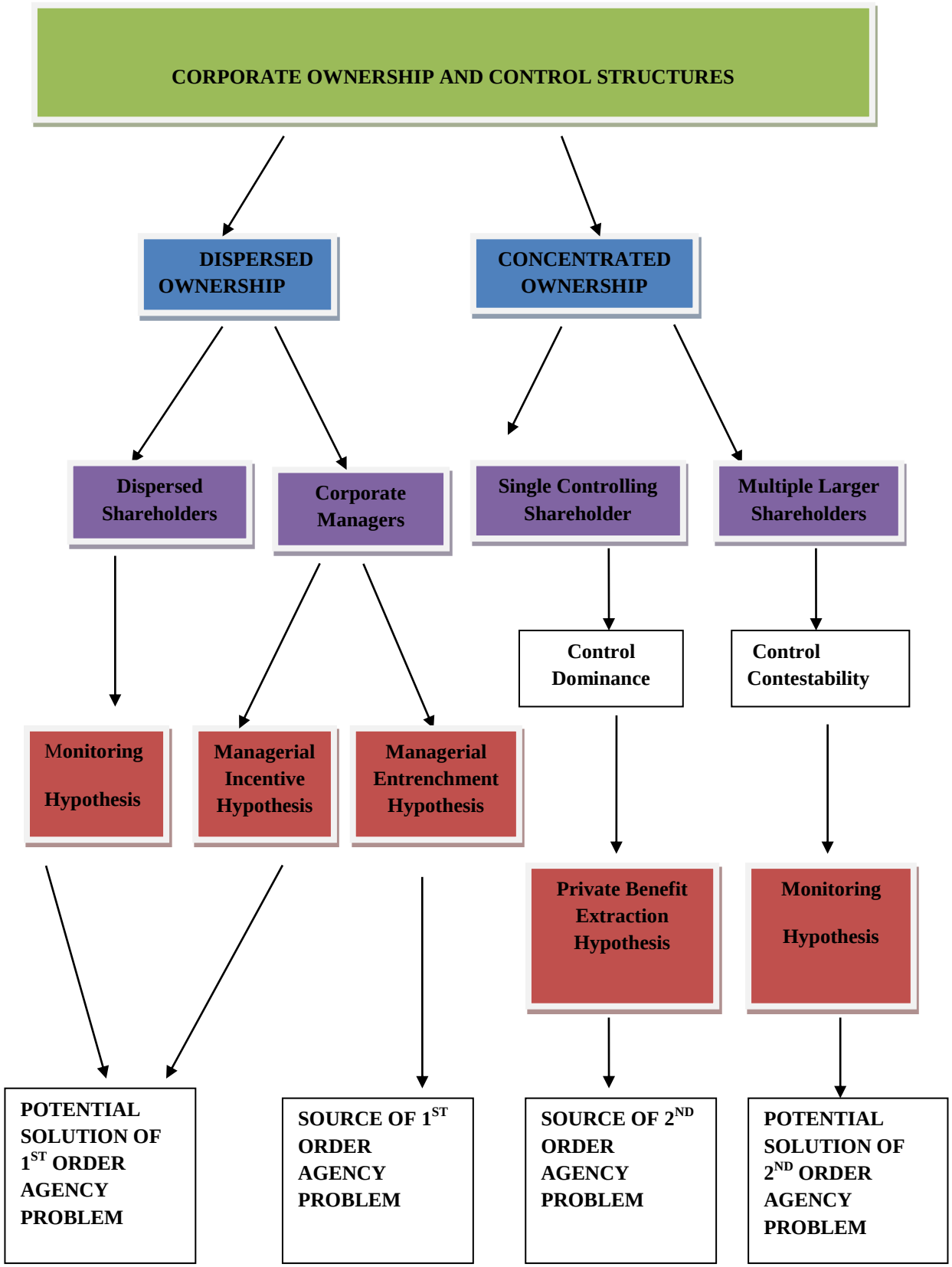
Following the above arguments it is expected that, controlling shareholders with larger cash flow rights have less incentive to refrain from expropriation as opposed to that controlling

shareholder whose cash flow rights is smaller. It is very likely that those controlling shareholders with smaller cash flow rights would consider private benefits extractions. It follows, therefore, that controlling shareholders pursue private interests less when their ownership stake is larger consistent with Claessens *et al.* (2000), La Porta *et al.* (2002), Laeven and Levine (2008) and Gompers *et al.* (2008).

Debt may be used by controlling shareholders in pyramid firms to enhance expropriation by forcing their subsidiaries to raise more external debt, reorganising this via intercompany transactions and finally facilitating deployment of corporate resources for their own preferred projects (Atanasov *et al.* 2009). However, the expected bankruptcy which is considered as the disciplinary mechanism for over-usage of debt is declined because controlling shareholders in pyramid firms have limited liabilities for insolvency of their subsidiaries and the loss of reputation is minimal due to the difficulty of holding them responsible because of the complexity of the control web. Following this argument, it may be suggested that, in pyramid firms debt is used to facilitate expropriation of minority shareholders rather than using it to enhance control as expected in stand-alone companies. According to Johnson (2000), in affiliates located at the bottom of the pyramid structure, controlling shareholders have higher voting rights but low cash flow rights.

The deviation between the two rights creates incentives to transfer resources from the bottom to the top where controlling shareholders have larger cash flow rights. Johnson, (2000) refers to this transfer of resources as "tunnelling". According to Johnson, tunnelling include, among others, *a wealth transfer among affiliate firms through transfer pricing, using assets of one group member as collateral for another, inflated payments for intangibles such as patents, brand names and insurance.* The theoretical framework of this thesis is diagrammatically presented in diagram 2.1.

Diagram 2.1 Diagrammatical Representation of a Theoretical Framework



CHAPTER THREE

3.0 LITERATURE REVIEW

3.1 CORPORATE OWNERSHIP AND CONTROL

3.1.1 Introduction

This chapter presents the detailed literature review of the whole thesis. The literature is subdivided into three broad subsections. The subsections are preceded by the overview of ownership and control around the world. In the first section (4.2) the literature focuses on ownership and control in relationship to corporate performance. This is followed by another sub-section which provides an overview of determinants of capital structure and important capital structure theories before ownership-capital structure related literature is discussed in section (4.3). The last sub-section starts by discussion of theories of dividend policy and finally carries out an empirical review of ownership and control related literature (4.4).

3.1.2 Overview of Ownership and Control around the World

The agency problem existing between managers and shareholders which was identified by Berle and Means (1932) is not usually prevalent in economies where ownership structure is concentrated. According to La Porta *et al.* (1999), in many economies the core agency problem is that between minority shareholders and controlling shareholders. Controlling shareholders in these economies use their control to extract private benefits at the expense of other shareholders.

The literature reports a variation of ownership structure across countries. According to the report by Majluf *et al.* (1998), in Chilean large companies larger block holders control 40% of equity holdings but this falls to 22% when it comes to German enterprises and further drops to 7% for Japan. However, the situation becomes quite different when it comes to US ownership structure. According to the authors, in the US the largest shareholder does not hold

voting rights larger than 5% and in Japan the top five shareholders have over 30% of public companies' control.

Furthermore, the popular study by La Porta *et al.* (1999), using a global sample of the largest 20 publicly traded companies in each country, shows that 36% of the companies were widely held while 30% had their control in the hands of families. The study also reports that 18% of the sample was government-controlled and 15% is controlled by other types of investors. According to the authors, pyramidal structures are primarily used by major shareholders to control companies and 26% of the sample firms used pyramidal structure in separating corporate control from ownership. Apart from Germany, the authors found little control evidence by single investors such as banks and other financial institutions.

In contrast to La Porta *et al.* (1999), Faccio and Lang, (2002) in their Western Europe study, using their sample of over 5000 companies reveal that ownership structure in Western Europe is either diffused or firms are controlled by families. According to Becht and Mayers (2001), most European countries have concentrated ownership where voting is concentrated in a few investors' hands - very different from the UK and US where ownership is spread among different shareholders.

In line with Faccio and Lang (2002), Becht and Mayers (2001) report a concentrated ownership with the presence of block owners in firms located in Austria, Belgium, Germany, Italy, Spain and The Netherland. In these countries the largest holding for the median firm is greater than 50%, as reported by the authors. In their study the authors report relatively weaker evidence to support the presence of dominant block ownership in the UK. This shows that in a large part of the Continental Europe, corporate managers are capable of being controlled by block holders in such a way that they may not be able to divert corporate resources to activities which jeopardize firms' value. As in La Porta *et al.* (1999), therefore,

the major conflict of interest becomes that between majority shareholders and minority shareholders.

More recently, departing from the traditional understanding that the US and UK have dispersed ownership structure, Laeven and Levine (2008) report uncommon results where almost 75% of UK companies have either multiple large shareholders or one large shareholder. More specifically according to Laeven and Levine, 26.7% of firms have no controlling owner, and 42.8% have one controlling owner while 30.5% of the sample represents companies with multiple large shareholders.

When comparing group affiliation in seven East Asian countries and Chile, Claessens *et al.* (2000) provide evidence that, while 40% of Chilean firms are associated with business groups, the reported proportion of listed firms in East Asia associated with business groups goes as high as 75%. In Brazil, as reported by Valadares and Leal, (2000), ownership concentration is a common phenomenon whereby on average the major investor holds 41% of shares of publicly traded companies.

Similar to the situation in Western Europe, Claessens *et al.* (2000) present an argument that voting rights and cash-flow rights are well separated in East Asian corporations and there exists minority shareholders' expropriation accompanied by lower corporate values. Capital markets similar to those of East Asia where expropriation of minority shareholders is a common practice, have a requirement of paying higher dividends by corporations affiliated with tightly controlled groups (Faccio, Lang and Young, 2000).According to the authors, in these capital markets shareholders without sufficient control level are not able to extract higher dividends. It therefore follows that, a larger deviation between ownership and control yields lower dividend rates.

Empirical evidence shows that the ownership structure of many companies in different parts of the world is neither dispersed nor concentrated. In most companies at least there is a second largest block holder. The presence of the second largest shareholder, according to Laeven and Levine (2008), is associated with monitoring of the largest shareholder against expropriation of minority shareholders. The authors, in their European Union study, show that, in eight out of nine popular stock markets the average size of the second largest shareholder in large publicly quoted companies is more than 5%. This is supported by La Porta *et al.* (1999) who report the presence of second largest shareholders in about 25% of companies in a selection of countries.

In their study, Laeven and Levine (2008) report that, 34% of listed companies in Western Europe have more than one large shareholder, while 12% of the companies have above two large shareholders. The authors consider a large shareholder as a share owner with at least holdings of 10%.This study attracts more attention to several researchers because contrary to traditional beliefs that most US companies have dispersed ownership structure, Laeven and Levine report new results that even US companies have large shareholders. In their study they find that about 90% of US companies in S&P 500 have shareholders with holdings above 5%.

The study of Holderness (2009) supports the contention by Laeven and Levine that ownership structure in the US is now becoming concentrated. Holderness finds that 74% of US stock is owned by multiple block holders and 26% of his sample firms is made up of companies owned by at least four block holders.

Consistent evidence on the presence of multiple large shareholders in the US is also reported by Dlugosz *et al.* (2005) who report that 70% of US companies have multiple block holders with 57% being outside block holders while 26% are companies with at least four block

holders of which 17% are external block holders. The authors use a threshold of 5% to measure block holdings.

Empirical literature supports the role of the second largest shareholder in monitoring the behaviour of the largest shareholder. Lehman and Weigand (2000), in their German-based study, present evidence that the presence of a second large shareholder improves the profitability of Germany listed companies. Another study is presented by Volpin (2002) using Italian companies and the results of this study reveal that when several shareholders form a control coalition the market value of the company is higher than when the firm has a single block holder.

Maury and Pajuste, (2005) report that in Finland 48% of companies have more than one block holder. Furthermore, according to Maury and Pajuste (2005), when the largest two shareholders have similar interests the presence of the third largest shareholder is very important to rescue the largest shareholders from diverting the wealth of minority shareholders, because the third largest shareholder will monitor the behaviour of the top two shareholders. This improves corporate value.

Using data from 8 East Asian and 13 Western European countries, Attig *et al.* (2008) report the evidence of decreased implied cost of equity due to the presence, number and voting size of other block holders beyond the controlling shareholder. Furthermore, the study reveals that the identity of the second largest shareholder, in family controlled firms, is a crucial control device for the largest shareholder and prevents a controlling shareholder diverting a company's resources.

The authors also find that the presence of multiple large shareholders in East Asian firms is used as an internal governance tool with the objective of preventing private benefit extraction

and reducing information asymmetry. Likewise, Faccio *et al.* (2001) in their Asia and Europe study reveal that the number of block holders is directly proportional to the level of dividends.

In their global study on the impact of multiple shareholders on the relationship between cash holding and firm value, using firms from 22 countries, Attig *et al.* (2009) find that the value of a firm's cash is improved by the presence of multiple large shareholders. They show that the even distribution of shareholders' voting rights is directly proportional to the value of cash holdings of the firm. They also find that higher control contestability is positively related to the value of a firm's cash.

It has been seen from this overview that ownership and control of corporations vary across countries due to the different institutional and legal characteristics of these countries. The section summarises the nature of ownership and control of different countries. The following section presents the literature which examines the specific impact of corporate ownership and control on financial policies and performance.

3.2 Ownership, Control and Firm Performance

3.2.1 Ownership Concentration

Most studies which relate ownership concentration and firm performance remain inconclusive insofar as the direction of the relationship is concerned (Demsetz & Villalonga, 2001; Sanchez-Ballesta & Garcia-Meca, 2007; Thomsen *et al.* 2006). All these studies try to investigate the monitoring role of large majority shareholders in solving agency problems. The studies in this area are preceded by the famous thesis of Berle and Means (1932) who suggested a positive relationship between ownership concentration and firm performance. Since then a series of findings have been reported concerning this relationship ranging from those supporting the results of the thesis (Jensen & Meckling, 1976; Zeckhouser & Pound,

1990; Xu and Wang, 1999; Burkart *et al.* 1997; Claessens *et al.* 2002; Pedersen and Thomsen, 2000) to those suggesting contrasting results, namely that the ownership concentration is negatively related to the firm performance (Fama & Jensen, 1983; Morck *et al.* 1988; Shleifer & Vishny, 1997).

The support of the positive relationship is explained by "incentive effect" as suggested by those supporting the relationship. According to them, this is the effect whereby, due to the large portion of shares they hold in a company, shareholders will have an incentive and ability to monitor closely the company's decision making process to prevent misappropriation of corporate funds by managers. In this stream of findings, the ownership structure is used as a corporate governance tool to solve the first-order agency problem, the conflict of interest between shareholders and managers.

The group of researchers who support a negative relationship between ownership concentration and firm performance claim that as the level of ownership of large shareholders increases there is the possibility of the "entrenchment effect" occuring and large shareholders may develop an opportunistic approach to expropriate minority shareholders. In this case the majority shareholders, using the control they have, might be able to divert company resources to increase their own wealth at the expense of minority shareholders' wealth by influencing corporate managers. This leads to the negative performance effect of ownership concentration. This line of results suggests that, ownership concentration is the source of second-order agency problem which is the conflict of interest between majority shareholders and minority shareholders.

A third group of researchers find no relationship between ownership concentration and firm value. The most popular study which challenged the work of Berle and Means (1932) is that of Demsetz and Lehn (1985). Demsetz and Lehn claim that, there is no systematic

relationship between ownership concentration and firm performance as corporate ownership structure is endogenously determined. This finding was then confirmed by several studies which followed thereafter such as Murali and Welch (1989); Demsetz and Villalonga (2001); Minguez-Vera and Martin-Ugedo (2007) and Omran *et al.* (2008).

The last group does not believe in a linear relationship between ownership concentration and firm performance. Among these studies, the best known is Morck, Shleifer and Vishny (1988) whose empirical evidence suggests a curvilinear relationship between ownership concentration and firm performance. This bell-shape relationship is supported by McConnell and Servaes, (1990); Stulz (1988) and Hermalin and Weisbach, (1988).

A new line of cross country research brought about by Thomsen *et al.* (2006) show that in countries with relatively low ownership concentration such as UK and US, there is no relationship between ownership concentration and firm performance, whereas those countries with higher ownership concentration experience a negative relationship between ownership concentration and firm performance because of the potential conflict of interest between majority and minority shareholders.

It is worth noting that the relationship between ownership concentration and firm performance is moderated by the institutional environment as highlighted in Dalton *et al.* (2003) and Sanchez and Garcia (2007). According to these authors, the relationship between ownership concentration and firm performance is stronger in continental countries than in Anglo-Saxon countries like the UK and US. This directly takes us to the contention commonly adapted from La Porta *et al.* (1998) that ownership is more positively related to firm performance in countries whose level of shareholders' protection is lower.

3.2.2 Ownership Identity

Apart from ownership concentration, the focus has now been shifted to ownership identity because it is currently realized that the identity of shareholder matters significantly as claimed by Thomsen and Pedersen (2000). Similarly, Cronqvist and Fahlenbrach, (2009) support the view that shareholders' identity has an impact on firm value.

In their study on the relationship between type of block holders and investment in research and development, Tribo *et al.* (2007) find that the impact of large shareholders in exploring investment opportunities is heterogeneous across investor types. The authors report that the relationship between investment and large shareholdings is negative when banks are the controlling shareholders while the relationship tends to be positive when block holders are non-financial corporations. An extension of this study was made to involve the relationship between block holders' type and firm performance and they report that the block holders' type is an important influential factor of firm performance.

3.2.3.1 Institutional Ownership

The rights of large shareholders diverge from country to country due to institutional differences. This makes it difficult to make comparison across countries. Institutional investors are represented by a board of directors which they appoint. Through the board they can hire and fire management and also they can refuse to sanction the decisions which are not consistent with their value-maximizing goal (Becht *et al.* 2005). The institutions have been the most common external shareholders, especially in the UK as their monitoring contribution in the capital market is now highly recognized.

Different countries have different definitions for large shareholdings depending on the minimum disclosure requirement of the particular country. In the UK, for example, the

shareholder with ownership of at least 3% must be disclosed. In the US disclosure cut-off is 5%. The presence of this group of owners has a vital role to play in an organisation. Shares of most public companies are owned by multiple owners. Some owners have lower levels of ownership while others have higher levels.

The incentive on shareholders to pay special attention to control and monitoring depends on the amount of money they have attached to shares of a particular company. The smaller the share holdings, the lower are the incentives to monitor and vice versa. Therefore, small shareholders will have little interest in incurring monitoring costs such as information costs whereas large shareholders may have an economic justification of doing so due to the value of their stake (Shleifer and Vishny, 1997). These authors contend that it is economical for larger shareholders to perform monitoring of management because they have the required skills and expertise. It can also be argued that, because of the size of their ownership there is an economic justification in doing so, since better performance of the company, associated with their monitoring, will bring them further benefit.

Monitoring by larger shareholders may reduce the free-rider problem resulting from selfish managerial behaviours. According to Shleifer and Vishny, Managers may take on more risky projects which favour their own interests and benefit especially if they can share the associated costs if projects fail. This is known as the free-rider problem. The monitoring imposed by larger shareholders on company's managers reduces to some extent this problem and the presence of large institutional investors increases the credibility of the company to the external world. Apart from benefits the whole firm is deriving from monitoring by institutional shareholders, minority shareholders are affected by the control held by the majority shareholders.

According to Denis (2001), larger institutional shareholders accumulate benefits which are not enjoyed by minority shareholders and generally they take advantage of their decision making power at the expense of minority shareholders. In a study on pension funds, Woidtke (2002) finds a performance difference between public and private pension funds. The author reports that there is a positive relationship between firm performance, measured by Tobin's Q, and proportion of shares owned by private pension funds while the relationship between ownership by public pension funds and performance is negative. According to the author the reason for the difference in performance is that, unlike private pension funds whose interests are aligned with those of shareholders, public pension fund managers are more motivated by political or social influences. On the other hand, Yuan *et al.* (2008) investigated the role played by mutual funds in China as activists and find that mutual funds ownership has a positive impact on firm performance. These findings are supported by Cornett *et al*. (2008).

However, other studies on mutual funds and pension funds suggest contrasting results. Among others, one can cite Black (1998), Romano (2001), and Gillan and Starks (2007) whose activists program do not create significant benefits to shareholders. More recently, the focus of many researchers has shifted to hedge fund activism. Unlike pension and mutual funds, Brav *et al.* (2008) contend that, hedge funds have the ability to influence company managements and boards of directors due to the incentives they offer. According to the authors, hedge funds employ managers who have high incentives and manage large unregulated pools of capital unlike pension and mutual funds which are much more regulated. Likewise, Greenwood and Schor (2009), and Boyson and Mooradian (2007) suggest the undervaluation of targets' stocks as the major motivation of hedge funds' intervention. In such cases, funds do not state specific objectives.

Contrary to Brav *et al.* (2008), who confirm the significant role of owners' identity on firm performance, Dai (2007) finds that while venture capital investors gain substantial ownership, keep their shares for a long time and take charge on the boards by requesting seats, hedge funds, on the other hand, rarely join the board room discussion by having seats. According to Dai, hedge fund investors do not hold their stakes for long before disposing of them. This confirms that investment by venture capitalists adds more value to a company as compared to investment by hedge funds

3.2.3.2 Managerial Ownership

Managerial ownership is considered as one of the corporate governance mechanisms which can solve the first order agency conflict, the conflict between managers and corporate owners as introduced earlier in 1932 by Berne and Means and confirmed later by Jensen and Meckling (1976). This conflict arises because managers have their own interests which are not in line with the interests of the owners. The basis of the contractual agreement between managers and corporate owners is that managers have to protect the interest of owners of the firm to maximize owners' wealth (Anup Chowdhury, 2007). Practically managers' interests do not align with owners' due to selfish managerial behaviour. The literature suggests various ways to align the two interests for the betterment of the corporation as a whole. This may be done, first by threatening managers and putting their employment at risk either by inviting takeover possibilities or dismissal threat (Thadden, 1990) and second, by implementing promises on bonuses, increase in salaries, peer pressure and board monitoring as suggested by Roe, (1994). The stick or the carrot!

According to Jensen and Meckling (1976), personal benefits derived from managerial power have a negative impact on the share price because this damages corporate credibility in the sight of potential and existing shareholders and this might also affect share price. So to build

a sound reputation and to make investors confident about a company's future, managers should convince investors to assure them that the resources of the company are protected from misallocation. One of the ways of doing that is the participation of management in corporate share ownership. This may imbue an ownership spirit in the managers and in so doing the managers' and owners' interests are aligned as they both have a goal of maximizing the corporate value.

However, according to Morck *et al.* (1988) and Stulz (1988) a higher level of managerial ownership is also dangerous because this may grant managers more power to make more risky investments and this may put the value of the firm at risk as the managerial entrenchment becomes severe. Literature has suggested that it is possible to identify different impacts of managerial entrenchment. Among others, Denis *et al.* (1997) suggest that the increased possibility of entrenchment weakens the disciplining role of internal control in the company because managers become too powerful to make decisions which may harm the company's resources. Another way in which managers can entrench themselves is by forming a board of directors which is unable to monitor their actions (Faccio and Lasfer, 1999 ; Coles, Lemmon and Wang, 2008 ; and Guest, 2008).The entrenchment effect can also be related to the CEO turnover. According to Huson *et al.* (2001), this event is very rare for those companies with a significantly higher level of management ownership suggesting that the entrenchment effect prevents the turnover. Managerial shareholdings and adverse selection problems caused by agency relationship are closely related to managerial ownership (Fahlenbrach, R, 2009.)

Coles *et al.* (2006) contend that, when an agency problem increases, the level of managerial shareholdings goes up at its optimal level and these problems are more serious in companies which face higher level of information asymmetry. For this reason, managerial shareholding

is more severe in smaller companies than larger ones. Coles *et al.* (2006) refer to smaller firms as younger ones implying those firms whose balance sheet consists of more research and development expenditures, more investment opportunities and intangible assets.

Leland and Pyle (1977) build on Coles *et al.* (2006) by claiming that, in situations where the information is highly asymmetric, the level at which managers participate in share ownership indicates good quality in the firm's cash flow. According to Myers and Majluf (1984), a company's management should choose to sell shares strictly when there is a benefit derived from such sales, in an attempt to maximize owners' wealth. Myers and Majluf refer to this as managerial ownership and adverse selection, whereby transaction in shares is quite uneconomical and expensive in a situation where information is not symmetrical.

During financial hard times managers become cheaper providers of funds to the company. Myers and Majluf (1984) suggest that, if the firm trades its shares with either cash or managerial service, an increase in managerial shareholdings results in extra resources for the company. Due to the insider information they have, managers may be involved in trading shares of the company which they believe are not correctly valued by the market. This grants managers significant benefit, at least in the short term, because in the long run the market may detect this faulty valuation and regulate the price.

To further expand the argument of Jensen and Meckling (1976) on how crucial managers' contribution is to firm performance, different writers have carried out significant research on this line of argument. When trying to describe ''*the self-serving management hypothesis*'', Benston (1985) highlights that, it is important to involve managers in the ownership of the company because their wealth improvement will directly depend on the firm's performance, therefore, they will work harder to increase their wealth which in a way aligning their interest with owners'. A couple of studies support this view, for instance Kaplan (1989) finds that

after existing management acquires the larger part of a company' shares, the firm's performance increases sharply. This shows that, managers did not have an incentive to manage better before they acquired the shares; hence, this suggests that managerial ownership is vital in improving share value.

Several empirical studies report no or only a weak relationship between managerial ownership and firm performance (e.g. Demsetz and Villalonga, 2001; Loderer and Martin, 1997; Faccio and Lasfer, 1999).

Other studies find a non-linear relationship. For instance, Morck *et al.* (1988) who find a positive relationship between Tobin's Q and managerial ownership for ownership levels between 0 and 5 percent and above 25 percent. For intermediate levels, they report a negative relationship. McConnell and Servaes (1990) find a similar relationship in their study, although their turning point is between 40 and 50 percent ownership. In ownership levels between 0 and 20 percent, Hermalin and Weisbach (1991) report a positive relationship between firm performance and managerial ownership but the relationship becomes negative for other ownership levels. Other studies which support the non-linear relationship between managerial ownership and performance include Davies *et al.* (2005), Kim *et al.* (2004), and McConnell, Servaes and Lins (2008), which provide support for the non-linear relationship between managerial ownership and firm performance.

According to Demsetz and Lehn (1985), the non-linear relationship reported between managerial ownership and performances arises empirically because the studies do not properly take account of the firm's environment. According to the authors, ownership structure is endogenously determined; therefore, there should be no systematic relationship between managerial ownership and performance. Demsetz and Lehn (1985) argue that the level of managerial ownership ought to be set at a level which maximizes owners' wealth

given the shareholders' constraints. It therefore follows that, any changes in managerial ownership cannot increase firm value and that the cross-sectional relationship between managerial ownership and firm value is not easy to interpret.

However, although the non-linear relationship between firm performance and managerial ownership supports the agency theory, more recently Fahlenbrach and Stul (2009) investigated whether the relationship between managerial ownership and firm value is the result of the incentive effects of managerial ownership or of the endogenity of ownership. After controlling for fixed effect, and using lagged changes in managerial ownership to control for endogenity, they find that increases in managerial ownership increase Tobin's Q but decreases in ownership do not decrease it.

Concerning the impact of managerial ownership on earnings management, Chung *et al*. (2002) report a non-linear relationship between managerial ownership and earnings management. Furthermore, Zhang (2009) , using the U.S. market a laboratory for his investigations, reports that an arbitrage portfolio, long on shares with high managerial ownership and short on shares with low managerial ownership records an abnormal annual return. Likewise, Von Lilienfeld-Toal and Ruenzi (2009) find that companies where managerial ownership exceeds 5% earn significant, abnormal stock returns.

Regarding the impact on capital structure, Ortiz-Molina (2006) reports that managerial ownership and yield spread of corporate bonds have a concave relationship while Datta *et al.* (2005) find a negative relationship between managerial ownership and corporate debt maturity.

3.2.3.3 Family Ownership

Family firms have often been considered as the engine of economic development across the world (La Porta *et al.* 1998; Holderness, 2009).Studies which examine issues related to corporate ownership structure show that family control is represented in a large proportion of the corporate sector worldwide regardless of the different institutional and legal characteristics across countries such as the United States and Canada (Anderson and Reeb, 2003; King and Santor, 2008), Western European countries (Andres, 2008; Srae and Thesmar, 2007; Faccio and Lang,2002) and Eastern Asian economies (Claessens *et al.* 2000).

Most recently, some studies have focused on issues relating to family ownership and there has been growing interest among researchers in better understanding the peculiarities of family companies and their business model (Anderson *et al.* 2009; Villalonga and Amit, 2009; Chen *et al.*2010; Chen and Nowland, 2010).

Several unique properties are derived from these studies and are worth discussing at this juncture. First, according to Lee (2004) and McVey and Draho (2005), family companies are formed by combining two quite different entities, namely the family and the business. Consequently, family firms have their own specificities attached to their culture and values. According to authors, the culture and family values are set by the founders and thereafter shaped by the controlling family overtime.

Second, family firms are characterized as the long-term survivors because their concern is passing the wealth from one generation to the other (Anderson and Reeb, 2003). Therefore, family firms may not trade-off short-term profits for long-term growth as this will result in hampering the ultimate goal of the business.

Third, due to their long term focus, family firms would ensure that they maintain their reputation. According to Chen *et al.* (2008) and Chen *et al.* (2010), the concern of family firms is not only on the business reputation but also the founders' own reputation both of which are commonly intertwined.

Lastly, unlike widely held corporations, where managers have control over corporate assets and ownership is widely spread among shareholders (Jensen and Meckling 1976), in family firms managerial activities are performed by the owner manager either directly or indirectly (Anderson and Reeb, 2003; Andres, 2008).

Another strand of literature is of an opposite opinion, namely that family firms are actually non-performers. Literature consistent with this view considers family control as the source of agency problem between minority shareholders and majority shareholders (Villalonga and Amit, 2006; and Shleifer and Vishny, 1997). When the external world notes the possibility of this problem, family companies have a hard time expanding their investment base to attract new investors to buy their shares.

As regards the fusion between family and business, literature suggests that founders may make some decisions which favour family interests and hamper the firm's survival. An example of such decisions is appointing a family member to take over managerial positions so as to hand on the corporate control to the next generation (Perez Gonzalez, 2006; Bennedsen *et al.* 2007, Cucculelli and Micucci, 2008). Inheriting managerial positions is said to be detrimental to corporate value but beneficial to the founders because they maintain corporate control which offers them opportunities to create personal benefits (Volpin, 2002; Holderness, 2003). In this case the corporate value may be in jeopardy as a result of the inheritance of managerial positions by members of the family who may not have sufficient managerial skills.

Both cross-country and single-country studies report superior family firms' performances compared to the non-family firms. In Western Europe studies, Barontini and Caprio, (2006) and Maury (2006) report that family companies perform better than non-family companies but the performance of family companies becomes even more outstanding when the family firm has a founder CEO.

Evidence from single country studies is consistent with those of cross-country works but according to these studies family companies out-perform other companies depending on their characteristics. Srae and Thesmar (2007) in their Italian study reveal that, disregarding founder and outside management, listed family firms outperform widely-held firms. However, Srae and Thesmar additionally report that, most of the family firm's performance is directly linked to the presence of founders.

Another study which supports the superior performance of family firms is the German study by Andres (2008) who insists that family companies perform better than, not only widely held companies, but also other types of block holders.

In their popular study on multiple large shareholders in Finland, Maury and Pajuste (2005) find that, a controlling group where both first and second largest block holders are families performs worse compared to those controlling groups whose second largest member of the controlling group is a non-family company, particularly a financial institution.

Studies on ownership structure identify monitoring differences between family-controlled firms and firms controlled by institutional investors, hence their difference in performance. According to Chen *et al.* (2007), institutional investors' shareholdings stability varies significantly from other block holders like founding families due to the fact that founding family block holders are likely to trade less frequently compared to institutional investors block holders.

3.2.3.4 Foreign Ownership

A further subsection in the literature focuses on the superiority of foreign-controlled firms as opposed to their domestic counterparts. Financial theories reveal that international diversification accounts mainly for foreign financial investment but obviously diversification needs larger portfolios which require less time to analyse than smaller individual companies (Hurtsi, 2006). This leads investors to avoid risky companies and speculation in shares, choosing instead to invest in safe companies. Kang and Stulz (1997) recognize the safer firms as the larger ones which have attractive accounting profits and which produce good returns on their equity figures. The quality of a company is reflected in the level of cash a firm is holding. Previous studies such as those by Kim and Wei (2002) and Dahlquist and Robertsson (2001) reveal that international capital flow is mostly driven by past returns. Past performance of a company's shares is an indication that the firm will perform similarly in the future. Indeed, information regarding past performance of a company's shares is a measure of the company's financial health and is used by foreign investors as an aid to choosing companies in which to invest their cash.

Literature suggests that foreign investors, due to their lack of connection with the society in which the company is located, may take value-maximizing decisions which impact negatively on the lives of the local community, such as retrenchment of employees to reduce operating costs. According to Hill (2003), domestic investors would find this process much more difficult, due to their close attachment to the society in which they operate. Ferreira and Matos (2008), suggest that the presence of foreign investors without business links to their investees' companies significantly increases firm value. According to the authors, foreign investors are able to put appropriate pressure on managers of their investees' companies, as opposed to domestic investors who have business connections with the companies in which

they hold shares. The authors also find that foreign and independent institutions (those without business ties with their investees' companies) have higher operating performance and lower capital expenditure. This positive effect on performance is associated with the ability of large independent institutional investors in monitoring mangers of their investees' companies.

From Dalton *et al.* (2003), we learn that, according to resource dependence theory, there are potential benefits arising from different types of ownership. It should be understood that different types of shareholders, with their different capabilities, provide unique and rare resources which create a competitive advantage for a firm. Douma *et al.* (2006), suggest that a good example of this is foreign investors who, unlike their domestic counterparts, are associated with good monitoring capabilities and who use their stakes to secure new markets for the company's services or goods as well as to secure access to location-specific resources and low-cost production facilities.

These authors also state that foreign investors contribute knowledge and other non-financial resources apart from mere financial capital to organizations. While Djankov and Hoekman (2000), find that foreign owners provide managerial expertise and quality control systems, Douma *et al.* (2006) claim that, due to different foreign investors' investment profiles in different jurisdictions, foreign investors are expected to have a better benchmark understanding of what good governance is.

Additionally, as far as monitoring is concerned, firms which are controlled by international investors usually impose better monitoring quality than domestic-controlled firms. The reasons for this, among others, according to Douma *et al.* (2006), include organizational and managerial capabilities, quality control systems and systems of good governance. It is reported that foreign investors invest in different countries with different governance systems,

so using their diverse experience they may have a benchmark of what good governance is. It can further be learned from Lee (2009) that, firms which invite more foreign equity ownership receive superior monitoring due to the fact that foreign investors demand more transparency and better standards of corporate governance and therefore may take on the role of active monitors.

It is further highlighted by Yoshikawa and Phan (2005) that, the presence of foreign ownership exposes managers to pressure and limits them in their ability to respond to the strategic interests of domestic investors. Because the foreign investors have no close relationship with the firm in which they invest and in particular there is not any business link between them, it is expected that the increase in their shareholdings will improve the firm efficiency and thereby maximize resources allocation policy.

Several studies have reported the positive relationship between foreign ownership and firm performance. Wiwattanakantang (2001) using a Thai sample finds a direct relationship between firm performance and foreign ownership. A similar study of foreign ownership and firm performance in the Brazilian context confirms a superior firm performance, Willmore (1986). Boardman *et al.* (1997) using Canadian data reveal a performance difference between companies having higher foreign ownership and those having higher domestic ownership. According to Boardman *et al.* foreign-controlled companies perform better than their domestic counterparts. Literature further compares different owners' identity across nationalities.

Furthermore, studies by Mueller and Peev (2007) confirm a superior performance of foreign-owned firms in comparison to other categories of domestic equity owners such as state, pension funds, banks, insurance companies and industrial companies. Baek *et al.* (2004) report that during the Asian financial crisis, those companies which had no affiliation with

foreign investors' experienced smaller reduction in their share prices. Foreign owners - due to their reputations in the wider world - are said to have access to several resources such as funding. This is reflected in Koo and Maeng (2006) whose study shows that foreign ownership increases the ability of companies to access external finance. D'Souza, Megginson, and Nash (2005) in their study of newly privatized businesses report the superiority of foreign ownership on firm efficiency as their study reports a gain associated with foreign ownership

More recently, Leuz *et al.* (2009) after controlling the possibility that foreign investors prefer investing in companies with better performance and good corporate governance, confirm that companies with control in the hands of foreign investors outperform those companies which are domestically controlled. Consistent with Leuz *et al.* findings, is a Korean study by Choi *et al.* (2007) which reports similar results that increase in foreign holdings improves firm value. Another recent study is that of Lee and Kim (2009) reporting that foreign block holders and foreign directors are the source of firm better performance.

Another strand of literature suggests that, foreign investors are biased when selecting companies to invest in their fund and they put less value on the shares of companies with poor governance (La Porta et al. 2002; Lemmon and Lins, 2003; Nenova, 2003; Doidge, 2004; Dyck and Zingales, 2004; Klapper and Love, 2004; Lang, Lins, and Miller, 2004 and Kalcheva and Lins, 2007).

More recently, Leuz *et al.* (2009) using a US sample examined the relationship between foreign investment and insider control, finding that foreign investors invest less in companies with higher levels of insider control. The findings of Leuz *et al.* (2009) study are in line with the explanation that the information asymmetry problem faced by foreign investors contributes significantly to the decision of foreign investors to hold fewer shares of companies with weaker insider control. In support of this contention, Leuz *et al.*show that firms which engage more in earnings management attract less investment from foreigners and

ownership effects are stronger in companies with poor information flows and high insider control.

3.2.4 Limitations on Previous Ownership-Performance Literature

The mixed results are evidenced in more recent works. The first work is the Meta analyses of Sanchez-Ballesta and Garcia-Meca (2007) which involved 33 studies and the second (which involved more studies) is Essen and Oosterhout (2009). According to these studies it was highlighted that most of the past researches report different results due to various reasons including difference in performance measure, difference ownership measures and data quality, econometric issues such as curvilinearity and endogenity and difference in corporate governance systems. This section highlights studies which relate directly to these differences mentioned

3.2.4.1 Econometric issues and Endogenity

Critical examination of the literature reveals that earlier studies on ownership-performance relationship used single equation Ordinary Least Square models. The results of these studies remain contradictory to date. When examining the relationship between ownership concentration and performance measures based on accounting data, Gedajlovic and Shapiro (2002), and Oswald and Jahera (1991) found no relationship. Other studies with similar results are Demsetz & Lehn (1985); Holderness & Sheehan, (1988); Lehmann & Weigand, (2000); Mehran, (1995); Pedersen & Thomsen, (1999). Employing market-based performance measures, Anderson & Reeb (2003); McConnell & Servaes (1990); Morck *et al.*(1988) find a positive curvilinear relationship between ownership concentration and firm performance. All these studies with others of this nature do not take into consideration the possibility of a two way relationship between ownership concentration and firm performance. The results of these studies are

different depending on sample sizes, countries in which samples are taken and consideration of owners' identity.

It should be noted that ownership and performance have a two way relationship such that both variables can be endogenously determined. Due to this observation, simple regression on performance and ownership may yield unbiased regression coefficients in the presence of causal relationship or endogenity. The study of the relationship between ownership and performance is now matured due to the arrival of some advanced econometric tools which may solve the problems of endogenity. Among the tools which are used to take care of endogenity problem are simultaneous equation models (2SLS) and Granger Causality test. Using these tools, Agrawal & Knoeber (1996); Cho (1998); Demsetz & Villalonga (2001); Himmelberg *et al.* (1999); Loderer & Martin (1997); Miwa & Ramseyer (2003); Welch (2003) do not find any empirical relationship between ownership and performance.

According to Thomsen *et al.* (2006), the results of the studies do differ across countries and the difference originates from variations in average ownership concentration across countries due to different underlying corporate governance systems. Among many studies in this area, as reported in Pindado and Torre (2004) and Claessens and Djankov (2002), find an evidence of a weak robust performance effect of ownership concentration using 2SLS regression. More recently, Bhattacharya and Graham (2009) applied 3SLS regression in their cross-sectional study of Finland to explain the two way relationship between ownership and performance. According to them, the 3SLS technique is appropriate for the study which uses the cross sectional dataset because many institutional shareholders own multiple equity stakes in different firms. As a result, ownership and performance issues can affect each other in various ways. These interactions can be captured through 3SLS estimation technique. As in 2SLS regressions, under 3SLS setup, the choice of instrument plays a very important role.

Bennedsen *et al.* (2000), suggest that careful considerations of the choice of instrument should be made when estimating performance and ownership relationships. According to Wooldridge (2006), if instruments are not carefully chosen, in the presence of endogenity, the use of instrumental variables may yield worse unbiased estimates than a simple OLS regression.

It is suggested that, due to lack of a solid theory guiding the choice of instruments, a continual use of simultaneous equation yields doubtful results as they are subject to weak instruments. Past studies such as Agrawal and Knoeber (1996); Cho (1998) and Demsetz and Villalonga (2001) do not test for instrument quality and therefore their results, which are trusted and referred to frequently, may be misleading .Though this weakness is known to scholars, some recent studies still apply 2SLS and 3SLS instrumental variable regressions, for instance Bhattacharya and Graham (2009), Omran *et al.* (2008) and Maury and Pajuste (2005).

The literature suggests that some other techniques have also been used up until now to treat the endogenity problem. Such techniques include fixed effect panels' estimation and other panel data estimation techniques, event studies and Granger tests. Like simultaneous equations, 2SLS and 3SLS regressions, event studies and Granger tests also provide contradictory results. Some studies using these techniques report a positive relationship between ownership and performance. For instance Agrawal & Mandelker, (1990) and Renneboog,(2001) using event study methodology, find a positive relationship between ownership and performance .More recently, Cornett *et al.* (2008) and Thomsen *et al.*(2006) also used the Granger test to handle the endogenity problem in the relationship between ownership and performance and found a positive relationship

3.2.4.2 Measures of Performance

Different measures may be employed to measure firm performance but the most commonly used ones are accounting measures and market performance measures. Accounting measures which are popularly used are profitability (Demsetz and Lehn, (1985), return on assets and return on equity (Short and Keasey, 1999), (King and Santor, 2008) and market performance measures like Tobin's Q (Morck *et al.* 1988; McConnell and Servaes, 1990; Davies *et al.* 2005; King and Santor 2008; Bhattacharya and Graham 2009; Florackis *et al.* 2009). According to arguments given by Demsetz and Villalonga (2001), accounting profit rates suffer from accounting manipulation through different valuation methods of tangible and intangible capital which results in the variation of figures for different methods, unlike market-based measure like Tobin's Q which measures future firm performance.

Concerning the time perspective of performance measures, Demsetz and Vilallonga argue that accounting profit is backward looking while market value is forward looking, hence it should be decided upon whether one should base one's judgement on what management has achieved (using accounting measures) or what management has to accomplish in future. Based on "who" measures performance, the authors say that accounting-based measures are provided by accountants who are guided and restricted by their code of conduct while market value constraints are set through investors' business understanding and optimism/pessimism. In this case, as most economists are more knowledgeable about market constraints than accounting constraints, they are more likely to favour market ratios

More recently, Cornett *et al.* (2008) in examining the institutional ownership-performance relationship deviated from previous studies by introducing a different performance measure based on operating cash flows adapted from Healy *et al.* (1992). According to them, unlike

their operating cash flow measure which reflects the current performance status of the company, the Tobin's Q of a poorly performing company might be overestimated by premium from an expected merger and acquisition program. Different results are therefore expected from different studies which employ different measures of performance.

3.2.4.3 Measure of Ownership Concentration and Data Quality

In general, most studies reviewed so far try to define the link between the level of ownership concentration and firm performance. Several important dimensions of ownership concentration are not defined in one single variable - for instance shareholdings by the largest investor, shareholdings by the five largest combined together and the relative strength between owners, are all related to each other but they are used separately. In previous studies common measures of ownership concentration have been the percentage of the nth largest shareholder(s) and the estimation of Herfindahl index. Demsetz and Lehn (1985) considered percentage of equity owned by largest five and twenty five shareholders and Herfindahl-Hirschman index as a measure of ownership concentration. On the other hand, another influential study by Demsetz and Villalonga (2001) used only the percentage of the largest five shareholders to define ownership concentration.

Non-American studies have little choice on the measure of ownership concentration due to data availability. For instance, the recent study in Arab countries by Omran *et al.* (2008) uses the percentage of shares owned by the largest three shareholders. Likewise, Pedersen and Thomsen, (2000), dealing with similar relationships in Continental Europe, used the fraction of closely-held shares including the proportion of shares held by directors, officers, shares held by another corporation, shares held by pension plans and shares held by individuals owning more than five per cent. This measure is used because it is the only generally

available measure of ownership in Continental Europe and is the best measure in assessing owner identity as previously highlighted by Pedersen and Thomsen (2000). Even in more recent studies such as Cornett *et al.* (2008) on institutional ownership the authors still use the percentage of shares held by institutional shareholders. We further see another recent study by Bhattacharya and Grahams (2009) utilize the three indices; hi-share, hi-concentration and hi-difference.

Likewise in a recent study on a Korean sample Lee (2009) uses three measures of ownership concentration, namely percentage of controlling shareholders (those with substantial shareholdings), percentage of shares owned by institutional shareholders and percentage of shares owned by foreign shareholders. We should note also another recent study by Chen *et al.*(2007), using the percentage of shares owned by top five shareholders, the largest shareholder and that portion owned by block holders who hold at least 5% of total outstanding shares of the company. As in Lee (2009), Ferreira and Matos (2008) in their study on colours of investors use percentage of shares owned by foreign investors and domestic investors to measure the concentration of ownership.

It can, therefore, be concluded that no single measure can be used to represent ownership concentration. This lack of a common measure of ownership concentration is largely influenced by the lack of availability of ownership data in most countries especially outside the United States. The lack of a single common measure of ownership concentration leads to difficulty in making comparisons of cross-country studies. Concerning data quality it is found that most large companies and developed countries are over represented due to better information disclosure (Kole, 1995). For example a large percentage of studies in ownership structure are based on US data and many studies are currently mushrooming in the UK. However, for studies from non-US countries, larger firms are over represented.

3.3 Ownership and Capital Structure

3.3.1 Overview of Capital Structure and Capital Structure Theories.

The structure of a company's capital reveals the way funds are raised by the particular company in an attempt to exploit available business opportunities so as to increase the size of the company. The structure comprises a mix of different sources of finance being a result of the firm's financing decisions. More than half a century now since the popular paper concerning the corporate capital structure written by Modigliani and Millers (MM) was published in 1958, many studies on choices of capital structure have been conducted without a successful consensus among scholars. Particularly, the answer to the question asked by Myers over 25 years ago about capital structure choice is still a challenge to researchers. Some theories are established trying to answer Myers' question on how to choose the appropriate structure of firm's capital **.**In the section that follows some of the theories on capital structure choices will be discussed.

3.3.1.1 MM Irrelevance Theory

MM theory tries to derive a relationship between capital structure and the economic value of the firm. In their paper MM suggest that the capital structure choice has got nothing to do with the economic value of the firm and that whatever equity-debt mix is chosen, the value of the firm remains unchanged. The authors claim that the value of the firm is affected by the investment policy set out by the company and its assets' ability to generate income. The theory is built on the perfect capital market assumption that, investors both insiders and outsiders have perfect information, transaction in the capital market is free, a firm can perfectly substitute internal and external financing that means both sources are perfect substitutes and can be used interchangeably.

3.3.1.2 Static Trade-off Theory

As part of a financing decision process, a firm may set its target debt-equity ratio which it plans to move towards. According to Myers (1984), the ratio of debt to equity tends to change frequently in a process of achieving the targeted ratio. Financing a company's project using debt financing has its advantage over financing using equity sources. Financing using debt attracts a tax savings because the payment of interest on debt has a tax relief advantage to the firm, meaning that interest stands as a tax-deductible expense.

Apart from the advantage a company derives from the tax savings, applying more debt into corporate capital structure attracts a cash-flow volatility which in its extreme form can result in a bankruptcy risk. This makes debt financing more expensive as compared to equity financing where income from equity is subject to corporate taxes (Myers, 1984). According to Myers, application of debt in capital designing has both advantages and disadvantages to the company. Therefore, the company must balance the application of debt so that it gains in terms of paying relatively lower taxes and at the same time avoids bankruptcy costs. The act of balancing the two is referred to, by Myers, as the trade-off between gains from tax savings and the cost of bankruptcy. This reflects what is known as static trade-off theory of capital structure where the proportion of debt over equity in a firm's capital structure is balanced to achieve the debt-equity ratio which is optimal.

In a more general perspective, the presence of costs related to the chosen debt level, for instance costs due to bankruptcy, cost of debt etc results in bond holders' marginal tax rate being lower than the corporation tax rate, only if income from equity is left untaxed and this will result in a net advantage in using debt financing over equity. To be more specific the trade-off which is reflected in this theory is the balance between the tax advantage and costs related to debt financing as mentioned previously (Niu, 2008).

According to Niu, different companies have different targets of debt-equity ratios depending on some firms' specific characteristics and country specific factors such as financial systems, tax and bankruptcy laws etc. The theory goes further suggesting that, those companies which have relatively more taxable income and more tangible assets are said to have relatively higher debt-equity ratio.

Likewise, companies with more cash-flow risk and more intangible assets, whose value will not exist during liquidation, will have to place their reliance on equity financing because debt financing will not be favourable (Myers, 1977). Furthermore, the theory contends that firms with more profits - that means firms which have more tax savings will have higher debt-equity ratio. On the other hand, concerning growth opportunities, it is suggested that those firms with greater opportunities to grow should not be advised to engage in large borrowings because their values are predicted to be compromised severely in a case of financial distress when bankruptcy may occur (Myers, 1984).

3.3.1.3 Capital Structure Theory based on Agency costs

This is the theory based on separation of ownership and management of the business. It explains the way a company's capital structure is influenced by the cost of issuing debt and equity. Considering the issue of equity, according to this theory, because equity holders can not technically manage their assets, they employ managers who can manage the business on their behalf. Due to human nature, managers are less likely to protect the interests of the owners of the business as expected because they usually start with maximizing their own benefits (Niu, 2008).According to Niu, to make sure that managers interests and owners' are equally taken care of, owners must agree to incur some costs.

Among these costs are monitoring costs such as the forming of a board of directors and bonding costs of managers such as the cost of extracting contracts and costs related to managerial incentives such as bonuses and salary increases. Apart from bonding and monitoring costs there is also another cost known as opportunity costs, the cost that owners' wealth is reduced by managers investing in suboptimal projects (Niu, 2008). On the other hand, issuance of debt is advantageous to managers of the company because this gives them an incentive to undertake projects which are more risky but more potentially profitable. But the more risky is the project the more possibility exists of project failure because financial risk increases with application of more debt. If debt holders realise this they may increase the return on their investments to compensate the additional risk, hence increasing the cost of debt, including monitoring and bonding costs by debt holders and managers and bankruptcy costs (Niu, 2008).

3.3.1.4 Capital Structure Theory based on Information Asymmetry

Theories built on the basis of information asymmetry contend that insider individuals (including company managers) have access to very crucial and private information about stock returns which is not available to external investors. In this situation where insiders know more than outsiders about the stock price and investment opportunities of the company, debt level is chosen either to compensate for or mitigate poor investment decisions caused by lack of perfect information or to be used as the signal for those without inside information (Ross, 1977). According to Myers and Majluf (1984), based on information asymmetry, a pecking order hypothesis discloses the management's preference in the financing of projects.

According to pecking order theory, managers would prefer retained earnings to fund available profitable investments before they think of external sources. When it is necessary and external financing is unavoidable then debt is preferred to equity. One of the reasons why

managers prefer internal to external is that retained earnings are costless, i.e. they have no floatation costs on acquiring as opposed to external financing such as issuing debt and equity where floatation cost is involved. According to Myers, managers' preference for internal funding is also favoured due to the fact that no public disclosure on investment opportunities, as well as expected profits, is required. Myers provides the preference over which the financing order is followed if the external funding source is chosen by the company as follows: debt, convertible securities, preference shares and lastly ordinary shares. Companies also prefer to fund real investment by issuing securities whose risk profile is low apart from equity. In the case of equity, managers of the firm face a challenge in deciding whether to ignore profitable projects or issuing shares at a price which is perceived to be low.

3.3.2 Determinants of Capital Structure

A number of studies focus on factors influencing capital structure choice. The following factors are representative of many others and they are derived from the most recent findings of Frank/Goyal, (2007).

Firm's Growth: Opportunity for a firm to grow, measured as Market-To-Book ratio of equity, has been confirmed by several scholars to inversely correlate with debt in a situation where there are more investment opportunities than there are fund to explore such opportunities (Barclay *et al.,* 2006). In a situation where there are more funds than available investment opportunities, companies may weed out profitable projects due to existence of outstanding debt (Myers, 1977). According to Frank/Goyal (2007), the presence of growth opportunities tends to increase bankruptcy costs and therefore lower debt level; these findings are consistent with a theoretical view of trade-off-theory discussed in the previous section and inconsistent with the prediction of a pecking order hypothesis. Rajan and Zingales (1995) in their work, using Tobin's Q as a measure of growth opportunities, provide reasons for an

inverse relationship existing between capital structure and growth opportunities. These reasons are as follows: first, firms with high Tobin's Q experience higher bankruptcy costs and second, it is usually the preference of most companies to issue shares which are overpriced.

Profitability: Jensen (1984) emphasizes that the association between profitability of the company and its capital structure depends upon capital structure theory being in place. Trade-off theory emphasizes that, due to the tax shield provided by debt, firms which are more profitable than others have a composition of debt in their capital structure greater than the equity component in order to exploit tax savings benefits resulting from interest payments. Coming back to pecking order theory, there is a suggested negative relationship between capital structure and profitability due to the fact that companies usually start using internal funds before they start utilizing their external financing capacity. According to Rajan and Zingales (1995), it therefore follows that using debt will be the last option and will be considered after experiencing shortfall on internal sources. From pecking order theory perspective firms which have more profits are found to have a lower debt proportion in their capital structures.

In more recent studies such as Kayhan/Titman (2007) and Frank /Goyal (2007), as profitability increases leverage tends to increase as well, consistent with trade-off theory. Likewise, according to free cash flow theory, because larger profits imply more free cash flow, debt is believed to be a disciplinary mechanism on managers.

Assets Tangibility: Acquiring loans from banks requires security from the company. This security is to be used as collateral so that when the firm fails to honour its debt obligation the collateralized asset will be sold off to cover the bank's loan. Because only tangible assets are capable of backing up bank loans or used as collaterals, companies with a greater proportion

of tangible assets in their balance sheets are more likely to attract loans from banks. It is therefore sensible to suggest that, asset tangibility is directly related to debt (Frank/Goyal, 2007).

Earnings variability or Cash Flow risk: Earnings variability, measured by standard deviation of returns on assets, as used by Booth *et al.* (2001), is considered as a sensitive factor which affects capital structure. According to Booth *et al.* (2001), companies whose earnings vary significantly are vulnerable to bankruptcy risk. In this case, a company whose earning variability is large should have a lower debt ratio because their borrowing capacity is not that great, hence, such companies are forced to use equity to finance their new projects. This suggests a negative association between leverage and cash flow risk.

Liquidity: Frank/Goyal, (2007) measures liquidity as the ratio of current assets to current liabilities. This ratio, in corporate finance, is referred to as current ratio. It is implied from the pecking order theory discussed before, that companies have their own preferences when choosing the financing sources. The theory suggests that companies prefer retained earnings as an internal source of finance to external source; it is therefore obvious that companies form liquidity from accumulating retained earnings. Since retained earnings are the first option to fund investments at any point in time, the liquidity of the company is expected to be in jeopardy, hence, the liquidity of the company negatively relates to capital structure choice.

3.3.3 Ownership, Control and Capital Structure

The studies of the relationship between capital structure and ownership structure are usually based on the agency theory. Jensen and Meckling (1976) in their seminal paper support agency-based capital structure theory which advocates the manager-shareholders agency relationship. The authors highlight that the application of debt into capital structure cements the bonding commitment for managers. Without debt, managers may use corporate free cash flows to finance sub-optimal projects which meet their personal interests at the expense of owners' wealth. It therefore follows that the application of debt in corporate capital structure limits managers' ability to misuse company's free cash-flows (Jensen, 1986).

According to Jensen, managers of the company with debt obligation are forced to service the debt using the available free cash flows instead of extracting private benefits. Due to monitoring from debt providers, managers work hard to avoid default risk, preventing a shift of their power towards creditors and avoiding financial distress costs. As a result, the presence of debt is used as a device to enhance managerial efficiency and performance.

Jensen and Meckling (1976) also suggest that, when managers own part of the corporate structure, their ability to misuse corporate assets is reduced because share ownership instils a sense of co-responsibility into managers and this aligns the interests of managers and owners. According to Jensen and Meckling (1976), managers who have no ownership stake in the company may have an incentive to become involved in self-serving value-reducing activities such as perquisite consumption and empire building to expropriate the assets of the firm. These unfavourable activities which induce the firm with the agency costs can be reduced by

direct monitoring of management from external large shareholders (Shleifer and Vishny, 1997).

Different studies have attempted to investigate the relationship between institutional ownership and corporate capital structure and the empirical results remain mixed. Different sets of results are obtained from various studies concerning this topic. One set reports the positive relationship and the other reports the negative relationship.

Among the supporters of the positive relationship are Friend and Lang (1988), Firth (1995) and Berger *et al.* (1997).These authors contend this because - unlike managers - external shareholders may possibly hold a diversified portfolio by investing in several stocks. This may reduce part of their unsystematic risk. This suggests that, a higher level of debt does not matter so much to them. Likewise, the external shareholders would prefer more debt because they consider debt as a cheaper mechanism to monitor corporate management compared to direct intervention.

On the other hand, the set of findings which are consistent to the opposite results that, external ownership especially institutional ownership, is inversely related to debt, gain support from several scholars such as Grossman and Hart (1982) and Ross (1977). According to Ross, debt is used to substitute for institutional monitoring, since it reflects the quality of the company and assures the potential investors that the firm is capable of meeting the obligations associated with the debt. This may increase corporate share price. Likewise, according to Grossman and Hart, application of debt in the capital structure limits managers from misappropriating the company's cash flow. Therefore, debt is used as a control and monitoring device. From a corporate governance perspective, ownership structure and debt may be considered as internal control mechanisms which may be used to mitigate the agency costs (Zhang, 2009; D'mello and Miranda, 2010; Margaritis and Psillaki, 2010).

Apart from the direct impact of institutional ownership on corporate capital structure, Short *et al.* (2002) propose the indirect impact of institutional ownership on the capital structure through its capacity to influence the relationship between capital structure and managerial ownership. In the absence of institutional investors' monitoring, managers may use the power they have to undertake suboptimal investments which maximize their value at the expense of the company owners' wealth. The interaction of institutional owners serves to discourage selfish behaviour on the part of managers, because the monitoring role played by institutional shareholders may threaten managers' employment and as a result reduce the agency cost of equity

Likewise, the empirical results by Firth (1995) suggest that, after introducing institutional ownership into the relationship between managerial ownership and debt ratios, the negative association between managerial ownership and debt ratios is being diluted, meaning that the interaction of institutional investors reduces the impact of managers' choice of debt level which favours their personal interests.

Further literature (on the power of controlling shareholders) reveals that following their voting power, and considering that debt is used as a governance device, controlling shareholders would not use more debt in their capital structure because they already have enough control through their larger stakes and using more debt would not be advisable since debt is considered as a substitute of efficient monitoring power of the block holders. This argument is supported by Ellul (2008) who argues that companies with pyramid ownership structure and controlled by family use less debt because such an ownership structure itself provides enough control, such as could be expected from debt. Contrarily, using sample companies from 14 Europe and East Asia, Faccio *et al.* (2003) show that, debt is used by controlling shareholders of group affiliated firms to expropriate the shareholders of their subsidiaries.

Literature also highlights the impact of shareholders' heterogeneity in capital structure choice. Some studies show that, different corporate owners have different preferences on capital structure choice depending on their motives. Brav, (2009) shows that UK private firms use more debt in their capital structure than their public counterparts. Brav's results are consistent with Faulkender and Petersen (2006), who show that access to the public debt market is an obstacle for some companies to use debt in their capital structures. According to them, companies with less ability to borrow, such as private companies, will have lower debt level in their capital structures as opposed to those with access to the public debt markets such as public companies.

Currently, many studies on shareholder activism have changed their focus on hedge funds. One of the most recent studies is that of Klein and Zur (2009).According to Klein and Zur, firms targeted by hedge funds showed a significant increase in leverage. In their study it was shown that, regardless of the measure of leverage used, the level of debt increased. Similar results are reported by Greenwood and Schor (2009) who document the increase in leverage ratio by about 40% following firms being targeted by hedge funds.

Standards and Poor's (2005), credit ratings process considers corporate governance matters as part and parcel of the process itself. It is highlighted, in Standards and Poor's, that the existence of shareholders' heterogeneity accelerates conflicts of control. Using credit ratings as the proxy for debt quality, while Bhojraj and Sengupta (2003) find a negative relationship between bond ratings and the percentage of company's outstanding shares held by institutional shareholders, Ashbaugh-Skaife *et al.* (2006) report a negative relationship between number of block holders and ratings.

In a related study, using a cross-country sample, Boubakri and Ghouma (2010) explored the effect of governance on bond yield-spread and ratings. The authors report that excess

corporate control negatively relates to bond ratings. Their study further shows that the bond yield-spread has a positive and significant relationship with corporate control excess. When the results of this study are further examined, it is noted that there is a positive relationship between control by widely held financial institutions and bond ratings only when the control rests in the hands of the state. No significant relationship is reported between control excess and either bond ratings or bond yield-spread.

In their recent study on ownership structure and cost of borrowing, Chen *et al.* (2011) report that laws and institutions that constrain self-dealing and asset substitution related activities moderate the relationship between excess control rights and the cost of bank debt. The literature suggests that stronger shareholders' protection reduces self-dealing and tunnelling activities (Djankov *et al.* 2008) while strong creditor rights provide creditors with more power in the event of bankruptcy (Qian and Strahan, 2007; Houston et al. 2010). Chen *et al.* (2011) further report that both creditors' rights and shareholders' rights are negatively related to loan spreads.

3.4 Ownership Structure and Dividend Policy

3.4 .1 Introduction

After the firm has paid all its capital claimants like debt holders, suppliers, employees and other stake holders, the earnings remaining to the firm are distributable to the shareholders as the returns on their investment. It is important that managers decide how the shareholders can best be fairly rewarded. Two cash distribution options are available - namely cash distribution or capital gain (Dittmar, 2000). With regard to cash distribution, there are two alternatives to be considered. These are cash dividends and share repurchases. Three ways can be identified to look at dividend and share repurchases, according to Dittmar, (2000).

The first way is to consider both policies separately, that means the decision to choose either of the two is independent and they are unrelated. Secondly, dividends and share repurchases can be seen to be dependent on each other. That means if the company pays dividends it may not decide to repurchase shares and vice versa. The third way is that a company first decides whether it wishes to pay back capital to its shareholders. After deciding to pay back its capital, the firm chooses the method of doing so either through dividends or share repurchases.

According to Grullon and Ikenberry (2000), repurchases may be done through either of the following ways (1) the open market which is facilitated by a broker and usually at the current market price, (2) fixed-price tender offer where a firm offers its shareholders the opportunity to purchase back a specific number of shares at a given price before a given expiration date, (3) Dutch auction with a price that is not pre-specified, the firm sets a range of prices to repurchase its shares, or (4) Private negotiated repurchases whereby a direct negotiation occurs with majority shareholder.

It may be realized from Barclay *et al.* (2009) that, theories of firms' payout policy do not explain the observed forms of distributions to shareholders. The authors suggest that, although open market repurchases appear to have tax advantages, cash dividends are overwhelmingly chosen. According to the authors, since the costs of repurchases do not arise for cash dividends it is implied that repurchases are not generally chosen over cash dividends for making distributions to shareholders

The analysis done by Jagannathan *et al.* (2000) indicates that repurchases are an economically important source of payouts. According to their analysis repurchases are noticeably more volatile than dividends. Repurchases are reported to be responsible for a disproportionately large element of the variation in total payouts. According to Jagannathan, the smoothness of the dividend series combined with the volatility of the repurchase series are consistent with the view that dividends are paid out of sustainable cash flows while repurchases are paid out of temporary cash flows. Jagannathan further suggests that repurchases do not appear to be replacing dividends; rather they seem to serve the complementary role of paying out short-term cash flows.

3.4.2 Dividend Policy Theories

There are numerous theories which explain the reasons and timing of dividend payments.

The first theory is based on the risk reduction motive whereby investors would prefer to receive dividends rather than waiting for a future capital gain, largely due to concerns related to time value of money. Retaining cash flow in the business for reinvestment purposes may generate more cash flows in the future but the surrounding uncertainties may jeopardize the attractiveness of such an option. The name given to this theory is *"The Bird In Hand Theory"* (Gordon, 1963).

The second dividend policy theory as presented by Baker and Wurgler (2004) is known as *catering theory*. This theory suggests that, because shareholders' preference is crucial for corporate value enhancement, the corporation has to make a decision of paying or not paying dividends based on the preference of shareholders. If the investors prefer corporations which pay dividends then corporations should facilitate the dividends but when they prefer non-payers, corporations may cut dividends.

Another dividend policy theory is based on information asymmetry. This theory is referred to as the *signalling theory* as advocated by John and Williams (1985). According to the authors, dividends alleviate the information asymmetric between managers and shareholders by displaying inside information regarding a firm's future prospects. When the corporate pays dividends, the stock market considers this as a signal that the company has enough cash flow to meet its operational costs and remaining costs with cash distributable to its shareholders. This information boosts the share price while a dividend cut is interpreted by potential investors as bad news, namely that the corporation is struggling to meet its operational costs and hence has no distributable cash to owners.

Miller and Modigliani (1958), when laying down the foundation of dividend policy, showed that, in a smooth capital market, the payment of dividends does not have any impact on firm value or, put another way, dividend is irrelevant as far as the value of the firm is concerned. The theory was therefore named after their names, *MM Dividend Irrelevant Theory*. This means that any expected streams of cash payments through dividends can be replicated by the shareholders by purchasing and selling shares. The same reasoning applies to share repurchases which are also irrelevant in smooth capital markets. In the view of this theory, it is of no concern for shareholders whether to receive cash in terms of dividends or to wait for capital gain, as long as a firm's investment policies remain unchanged.

3.4.3 Agency Problem and Free Cash flow Hypothesis.

Accumulation of corporate excess cash flows has always been considered as the source of agency conflict between managers and shareholders and between majority shareholders and minority shareholders (Baker *et al.* 2002). According to the authors, selfish managers or controlling shareholders would use the free cash flows to create personal benefits by using free cash flows to explore projects of their own interests which are not consistent with the firm's goal of maximizing shareholders' wealth (Allen and Michaely, 2003).

According to Jensen, (1986), the market pressure for corporate control usually forces managers to distribute free cash flows to shareholders or else to risk corporate control. Consequently Jensen's free cash flows hypothesis suggests that share prices of companies with positive free cash flows should rise over time since management receives an appropriate reward. On the other hand, failure of management to increase corporate payout by investing on unprofitable investments, according to the hypothesis, will result into the drop of firm's value.

Lang and Litzenberger (1989) in testing the free cash flow hypothesis found that an increase in dividends has a positive impact on share prices of firms which overinvest compared to those which do not. The results of this paper reveal the agency role of dividends in solving the free cash flow problem. In terms of better use of free cash flow by management, La Porta *et al.* (2000) found that, in the countries with better investors' protection, the dividend payouts have been higher compared to countries with lower protection. These findings show that management does not have the incentive, on its own, to protect shareholders' interest unless it is put under control. This is always suggested to be the source of the agency problem.

3.4.4 Determinants of Dividend Policy

The following are some of the common factors derived from the literature which may affect corporate dividend policy;

Free cash flows: Jensen, (1986) defines free cash flow as the excess cash flow a company holds after exploring all positive NPV projects. The accumulation of free cash flow increases the agency conflict between managers and external shareholders. This conflict ultimately affects the corporate owners' wealth because shareholders may use the corporate excess cash flow to extract private benefits. Subsequent studies such as Jensen *et al.* (1992) support Jensen's free cash flow hypothesis. La Porta *et al.* (2000) adds that, regardless of the improvement of shareholders' protections, when a firm has free cash flow managers will engage in perquisite activities. Several studies have therefore suggested that companies with greater free cash flow should pay more dividends so as to prevent the misuse of corporate funds by managers and reduce the agency costs of free cash flow (Jensen, 1986 and La Porta *et al.* 2000).These studies imply a positive relationship between free cash flows and dividends payout ratio

Firm Size: Larger firms have commonly a dispersed ownership structure. In such firms there is a greater information asymmetry due to higher ownership dispersion and decrease in ability of shareholders to monitor the internal activities of the company. This ultimately increases the agency conflict between managers and shareholders. In such companies more dividends should be paid so that managers do not have excess cash flows on their hands (Jensen et al. 1992 and Fama and French, 2001).

Thus, based on agency theory, a positive relationship between firm size and dividend payout ratio is predicted as was previously suggested by Jensen and Meckling (1976). In case of any investment opportunity, managers should borrow from the debt market and subject themselves to control and monitoring from debt holders. This helps to reduce the misuse of corporate funds. A positive relationship between dividend payout ratio and firm size can also be justified on the basis of transaction costs. The theory suggests that larger firms with sound reputation and easy access to debt market can borrow at lower costs allowing payment of higher dividends to shareholders

Growth Opportunities: Several explanations of the relationship between dividend policy and growth opportunities can be identified from the literature. The first explanation is based on the pecking order theory of capital structure where a company with greater growth opportunities and large investments projects chooses to utilize its internal financing sources resulting in dividend-cut or paying fewer dividends to reduce the costs of external funding (Jensen, 1986; Lang and Litzenberger, 1989).Another explanation considers dividends as a control mechanism to limit managers who might indulge in wasteful behaviour by removing free cash flow from their control as suggested by Jensen (1986).Consequently, dividends are higher in companies with lower growth opportunities than in companies with higher growth opportunities because no free cash flow may exist for companies with higher growth since

whatever accumulates is reinvested (Jensen *et al.* 1992). When the two groups of companies (higher-growth companies and lower-growth companies) are compared it is found that high-growth firms exhibited lower debt than low-growth firms. The explanation for this is to reduce external finance costs as supported by Myers (1984); Murrali and Welch (1989) and Titman and Wessels (1988).

Financial Leverage: Several previous studies have shown an inverse relationship between leverage and corporate dividend policy (Jensen et *al.* 1992; Crutchley and Hansen, 1989; Faccio *et al.* 2001; Gugler and Yurtoglu, 2003). According to the authors, companies with high leverage look forward to maintaining that corporate liquidity so as to honour their debt obligations instead of distributing available excess cash to shareholders. Therefore, highly leveraged firms have higher transaction costs and are not in a position to pay dividends so as to avoid the cost of external financing.

Profitability: In corporate finance it is widely known that payment of dividends is subject to corporate profitability. Different studies have proved this contention empirically. Jensen *et al.* (1992) and Fama and French (2001) report profitability as a positive explanatory variable of dividend policy although this depends on the legal set up in which the company is operating. La Porta *et al.* (2000) report that, those companies operating in poor investor protection regimes may not receive dividends even if the company profitability is higher, because the controlling shareholders may divert the excess corporate cash flow to investments or activities which benefit them more. On the other hand those corporations with good investors' protection can pay dividends as profitability increases.

3.4.5 Ownership, Control and Dividend Policy

The foundation of the literature on determinants of dividend policy and dynamics is traced back to Lintner (1956). From this foundation, several empirical and theoretical studies have emanated. The results from empirical studies confirm three findings. The first one is that, when dividend payout increases, the firm value increases. The second finding shows the contrary, namely, a decrease in dividend payout reduces the firm value. The last category is the irrelevance of dividend payout to the firm value. This reflects the facts that the empirical evidence on the determinant of dividend policy is inconclusive.

In their study on dividend policy, agency cost and earned equity, DeAngelo *et al.* (2006) found that payment of dividends prevents significant agency problems because the retentions of distributable cash would have given the managers command over additional cash without access to positive NPV investment opportunities. The authors claim that, firms with high retained earnings are most likely to be dividend payers and they pay higher dividends when earned equity to total equity is high, and cut dividends when this ratio falls. The study confirms a significantly positive relationship between the decision to pay dividends and the ratio of earned equity to total equity, taking into account the control variables such as size of the firm, profitability, growth, free cash flows and leverage.

Using Greece as a sample, Eriotis (2005), examines the impact of distributed earnings and size of firm to dividend policy and reports that it is customary in Greece for corporations to have a dividend policy to distribute free cash flows to shareholders annually according to the target payout ratio.

In determining the factors that drive dividend and share repurchase decisions Brav et al. (2005) finds that, maintaining the dividend level is compatible with investment decisions

while repurchases are made out of the residual cash flows after investment spending. The study further reports that, managers are reluctant to cut dividends due to the negative consequence of reducing it, consistent with Lintner's findings in the 1950s.

After developing and testing a catering view of dividends that relaxes the market efficiency assumption of the Miller and Modigliani dividend irrelevance proof, Barker and Wurgler (2004) reveal that dividends are highly relevant to share value, but in different directions at different times. Moreover, managers apparently recognize and cater to shifts in investor demand for dividends. According to the authors; non payers tend to initiate dividends when demand is high while payers tend to omit dividends when demand is low. Their analysis confirms that these results are better explained by catering than other theories of dividends.

In testing tax-based dividend clienteles, Elton and Gruber (1970) report a fall of ex-dividend day stock returns following a decrease in a stock's dividend yield. The authors consider this to support the evidence of tax-based dividend clienteles. Elton and Gruber find that, investors in the highest yield stocks prefer dividends over capital gains, a preference they attribute, at least partially, to corporations' tax preference for dividends. Similar evidence on dividend clientele is reported by Litzenberger and Ramaswamy (1979) when they estimate an after-tax version of the CAPM.

More recently, Graham and Kumar (2006) report evidence in line with tax clienteles among individual shareholders. The preference for dividends among these shareholders seems to fall with income. This makes sense, because after tax-dividend is reduced by increasing marginal tax rates for individuals. It should be noted that corporate shareholders are in a different tax situation compared to individual shareholders who do not have the voting power to change dividend policy.

Considering the impact of large individual shareholders on corporate dividend policy, Pérez-González (2003) report an increase in dividend payouts in periods when dividends were less tax-disadvantaged compared to capital gains. The study further finds dividends increase for firms with large individual shareholders during periods of less tax-disadvantage. Generally, this study confirms that large individual shareholders affect dividend policy.

In a closely related paper, Barclay *et al.* (2009) test the association between large corporate shareholders and dividend policy. They argue that corporations prefer dividends more for tax purposes than any other group of shareholders. Examining the changes in dividends following trades of large blocks from individuals to corporations, contrary to Pérez-González, (2003), Barclay *et al.* (2009) find no evidence of dividend change in response to the new large shareholders' tax preferences.

As far as institutional ownership is concerned, Brav and Heaton (1998) and Binay (2001) report evidence of dividend clienteles among institutional investors. However, Allen and Michaely (2003), report evidence against a tax clientele effect namely that there is no evidence of the effect of institutional ownership on the level of dividends. According to the authors, institutional investors will be either tax averse or tax neutral toward dividends, depending on the tax status of their beneficiaries.

Fama and French (2001) report profitability, size of the firm and the investment opportunities as core factors which determine whether the firm pays dividends or not. The authors argue that larger firms and more profitable firms are more likely to pay dividends while dividends are less likely for firms with more investments. Their study further contends that former payers tend to be distressed. They have low earnings and few investments. Firms that have never paid dividends are more profitable than former payers and they have stronger opportunities. According to the authors, it can also be deduced that dividend payers are, in

turn, more profitable than firms that have never paid, but firms that have never paid invest at a higher rate, do more R&D and have a higher ratio of market value of assets to their book value than dividend payers. The authors, in their paper, further find that the decline after 1978 in the percentage of firms paying dividends is due in part to an increasing tilt of publicly traded firms towards the model of firms that have never paid- lower earnings, strong investments and small size. According to the authors, the evidence that, after controlling for characteristics, firms become less likely to pay dividends means that the perceived benefits of dividends have declined through time. Some of the possibilities according to them are: Lower transaction costs for selling stocks for consumption purposes, in part due to an increased tendency to hold stocks via open end mutual funds; larger holdings of stock options by managers who prefer capital gains to dividends and better corporate governance technologies that reduce the effect of dividends in controlling agency problems between stockholders and managers.

Using different institutional settings, Farinha and Foronda (2009) examined the relationship between the dividend policy and insider ownership. The results of their study reveal different findings due to different legal systems and the nature of agency conflicts in firms from different countries. The study reports that, in firms from an Anglo-Saxon tradition the relationship between managerial ownership and dividend is non-linear; first negative and then positive followed by another negative while in civil law countries the relationship is positive-negative-positive.

In testing the outcome model (dividends are paid because minority shareholders force corporate insiders to do so) and substitution agency model (insiders pay dividends when they are interested in issuing equity in the future), La Porta *et al.* (2000) use a cross country sample from 33 countries. Their study investigates the relationship between minority shareholder rights and dividend payouts. The results are in line with the “outcome model”.

Furthermore, this cross country study explored the relationship between family ownership and dividend policy and the results show that companies in those countries with better shareholder protection pay higher dividends than those in poor shareholder protection regimes. The study further highlights that fast-growth firms pay lower dividends than slow-growth firms in countries where minority shareholders protection is high. Shareholders are reported by the study to be willing to wait for their dividends when investment opportunities are good in countries whose minority shareholder protection is high compared to those in weak minority shareholder regions. The study suggests this mis-allocation of investments as part of the agency costs associated with poor shareholder protection.

In another study Faccio *et al.* (2001) show that European companies are better dividend payers compared to East Asian companies. The interpretation of this is may be associated to a lower level of ownership concentration in Western Europe as compared to East Asia, which shows evidence of expropriation of minority shareholders in highly concentrated ownership model East Asian firms. According to the authors, when the market anticipates the expropriation, the capital becomes competitive among corporations and dividends serve as an expropriation-reducing device as payment of dividends signals the financial health of the company. Moreover, in European corporations, the presence of multiple large shareholders is reported to be the catalyst for corporations paying higher dividends, implying lower expropriation of minority shareholders as advocated by Faccio *et al*. (2001).

Thomsen (2005) examines the relationship between ownership of the largest shareholder, dividend policy and firm value and reports that block holder ownership negatively affects firm value in continental Europe. The author also reports a negative impact of increase in block holder ownership on corporate dividend policy revealing an agency conflict between minority and majority shareholders

Executive entrenchment has been reported in several strands of the literature as the source of agency problem which exists between managers and shareholders. Entrenched managers may prefer not to be paying dividends because they would want to use distributable cash flows for other activities which can be to their personal benefit. It is reported in studies such as Hu and Kumar (2004) that the possibility of payout and its levels are positively related to factors that accelerate executive entrenchment. More specifically, the authors report that, the more tenured executives and those whose compensations are not stock-based are, the more likely they are to pay dividends. Likewise, independent boards, in their case, those boards with above 40% independent outside directors, also show a greater likelihood to pay dividends.

In the similar line of research, Kose and Knyazeva (2006) report that, managers whose interests are misaligned with the owners' are less likely to change dividend policy. The suggested reason for this is the worry they have by cutting dividends. Instead, the authors report that, in a situation where the company has excess cash flow, misaligned managers are more likely to repurchase stock than to increase/initiate dividends.

CHAPTER FOUR

4.0 DATA AND METHODOLOGY

4.1 Data Collection and Sample Choice

The sample used in this study comprises UK public companies listed on the London Stock Exchange. The raw data is adapted from Faccio and Lang (2002) which comprises 5,232 firms in 13 Western European countries between 1996-1999 after excluding all companies with no ownership data, companies which use nominee accounts and foreign affiliate companies whose ownership chain could not be traced. In this study 1,953 UK companies are selected from the raw ownership data and screened. Out of these, 442 financial companies are eliminated following the tradition in literature of excluding financial companies, as their reporting style and regulations are different from those of non-financial companies. This left us with 1,511non-financial companies. According to Rajan and Zingale (1995) in financial companies such as banks and insurance companies leverage is strongly influenced by explicit (or implicit) investor insurance schemes such as deposit insurance. Furthermore, their debt-like liabilities are not strictly comparable to the debt issued by nonfinancial firms. Hence, including this will bring contradiction as to whether the leverages of such companies are influenced by investor insurance scheme rather than by corporate ownership and control.

Using World scope database and DataStream; ownership data for 1,511 companies were matched with financial data. Companies' names were used due to the lack of companies' identification numbers from the sample source to search for the required financial data from the database. Several problems were faced; first, the names of some companies did not appear in the world scope database and DataStream, and hence no information could be retrieved. We suggested that such firms were either dissolved or the companies' names changed. In

some cases values displayed from a download were logically meaningless and such values, which are known as outliers, were not included in the study. Only companies with ownership values and at least three years financial values 1997-1999 were taken into account leaving the net number of sample firms to be 643. This sample size is roughly similar to that used by Laeven and Levine (2008) having 689 UK non- financial companies in their study of complex ownership and firm valuation. They also used the raw data adapted from Faccio and Lang (2002). The limited coverage of financial data is not considered to have introduced any bias to the tests because there is no any observed exclusion of certain types of companies from the study due to either missing information or any other described reasons. Hence this study considers the omission of companies to be random and unsystematic.

The source of raw ownership data used in this study is similar to that used in assessing the complex ownership and firm valuation in Laeven and Levine (2008) focusing on Western Europe and Attig *et al.* (2008) in examining the relationship between multiple large shareholders, control contest and implied cost of equity. This study focuses on the UK for several reasons: First, the UK is a relatively developed market compared to other Western Europe countries included in the raw sample and previous literature such as Frank *et al.* (2009) and La Porta *et al.* (1998) consider the UK to have better investor protection levels than most European countries. Therefore, studying corporate ownership and control, while mixing UK with other countries may not actually provide a real picture hence dealing with the UK separately is an ideal option.

Second, in Laeven and Levine (2008), it is indicated that about 42% of the whole Western European sample of firms come from the UK followed by 28% from France. This shows that the results of their study might have been driven by UK sample. Therefore, it is worth studying the nature of complex ownership and control in the UK separately.

Third, disclosure level for UK companies is higher relative to other Western Europe countries involved in the data set; hence the quality of UK data is also expected to be better. This is supported by Faccio and Lang (2002) when tracing the ultimate ownership of unlisted companies, as they put it: "*Where the ultimate owner of a corporation is an unlisted firm, we tried to trace its owners using all available data sources. We had incomplete success because most of our sample countries do not require unlisted firms to disclose their owners. One exception is the UK, where the 3% disclosure rule also applies to unlisted firms. If we failed to identify the owners of unlisted firm, then we classified them as a family*"

The raw ownership data for the UK is collected for year 1998. According to Cheffins (2008), in the early and mid -1990s dividends received by pension funds was tax exempt, until 1997 when this tax-free dividends incentive was abolished. It is this period where institutional investors grew rapidly in the UK as reported by Cheffins (2008) after a reversal in the tax treatment of dividends, which ultimately arrested the tax-induced purchase of shares by pension funds (from 32% in 1993 to 22% in 1997 and down to 16% in 2001). This shows that more pension funds which were holding a significant portion of UK equity rejected their holdings, as equity was no longer attractive to them. This resulted in a relocation of corporate equity ownership from pension funds to institutional investors.

Likewise, this period is considered to be within the period of prolonged strong economic performance and stock market boom in the UK (1994-1999) as identified by Renneboog and Trojanowski (2011). Hence, we don't expect to associate the results obtained from this study with any economic swing.

To study the impact of complex ownership and control structures on corporate financial policies and performance, the sample is categorised into firms with multiple large shareholders, single controlling shareholder, pyramidal structures and dual-class equity control structures. The criteria used to identify whether the firm has multiple large shareholders is similar to the one used by Laeven and Levine (2008) as in La Porta *et al.* (1999) and Faccio *et al.* (2002). A firm is considered to have multiple large shareholders if the largest shareholder owns at least 20% of the company's shares and the second largest has at least 10% of company's shares. To examine the impact of owners' identity on firm performance and corporate financial policy, the study divides the sample into different clusters such as, widely held listed companies with no controlling shareholder, widely held listed companies with financial institutions as controlling shareholders and companies closely held by family (which include individuals and unlisted companies).

4.2 Variable Constructions and Definitions

4.2.1 Dependent Variables

Financial Performance (Tobin's Q)

Several studies employ market-related performance measures like Tobin's Q (Morck *et al.* (1988); McConnell and Servaes, 1990), and more recently, Davies *et al.* (2005), King and Santor (2008), Bhattacharya and Graham (2009), Florackis *et al.* (2009) also use similar measure. Those who employ accounting measures like ROA and ROE, which are based on accounting profits, face some limitations. According to Demsetz and Villalonga (2001), accounting profit rates suffer from accounting manipulation through different valuation methods of tangible and intangible capital which results in a variation of figures for the different methods, unlike market-based measure like Tobin's Q which measures future firm performance. It is for these reasons that we consider Tobin's Q to measure firm performance

in this study. This variable is calculated as the market value of equity plus the book value of debt and preferred stock divided by the book value of assets following Hillier and McColgan (2008).

Financial leverage

Previous studies related to debt financing claim that the effectiveness of monitoring by debt holders depends on the level of debt. Debt holders become effective monitors if debt level reaches a critical threshold. The study uses Debt to Asset ratio to measure financial leverage similar to several previous studies such as Maury and Pajuste (2005) and Laeven and Levine (2008).This variable is used also as a control variable in the firm performance equation.

Dividend Payout Ratio

As with Jensen *et al.* (1992), when investigating the impact of agency theory and transaction cost theory, in this study, dividend is measured as dividend payout ratio, the ratio of dividend paid divided by net earnings. The ratio indicates the proportion of profits (net of depreciations, interests, taxes and other corporate expenses) distributed to the corporate shareholders. Both dividend payout ratio and dividend yield are used in this study.

4.2.2 Independent Variables

Ownership and Control Characteristics

In this study the largest fraction of voting rights is used to measure the impact of the decision making power of investors as adapted from Faccio *et al.* (2011). This measure is also used by Thomsen and Pedersen (2000) when dealing with the ownership identity. In this study, a controlling owner of the company is defined as the owner who has over 10% of company's votes like in Laeven and Levine (2008) as adapted from La Porta *et al.* (1999).According to the authors controlling over 10% of company's shares provides a sufficient power to

influence firm's decisions and more control is achieved by increasing their stakes in the company. If more than one category each owns above 10% of firm's shares, each of them are considered as large shareholders and the one with higher votes is considered as the controlling shareholder. In the case where the firm has no owner with above 10% of shares, such a firm is considered as widely held firm. Other cut-off such as 20% (Faccio and Lang, 2002) and 25% (Cronqvist and Nilsson, 2003) are also employed.

Calculation of Cash flow rights and Control rights

Corporate ownership is measured by cash flow rights and control by voting rights. Ownership is different from control because companies can issue different classes of shares that offer voting rights for a particular cash flow rights. Faccio and Lang (2002) used the weakest-link principle to measure control rights. According to the approach, a firm has an ultimate owner if a controlling owner with more than 20% and 10% value of voting rights can be identified. A firm is said to have an ultimate owner at a these thresholds if all the links in the relevant control chain exceed the threshold value. According to this approach, a firm is widely held if no ultimate owner can be identified using the principle and the relevant threshold value of voting rights. Faccio and Lang (2002, page 372) illustrate the approach as follows: if a family owns 15% of Firm X, that owns 20% of Firm Y, then Y is controlled through a pyramid at the 10% threshold. However, at the 20% threshold, we would say that Firm Y is directly controlled by Firm X (which is widely held at the 20% threshold) and no pyramiding would be recorded.

The links in the control chain that are recognised when measuring ultimate ownership via a pyramid are those where voting rights are less than 100 per cent. If, in Faccio and Lang's example, the family had all the voting rights in Firm X, then Firm Y would be said to be directly controlled by this family, with no pyramid involved. As far as ultimate ownership is

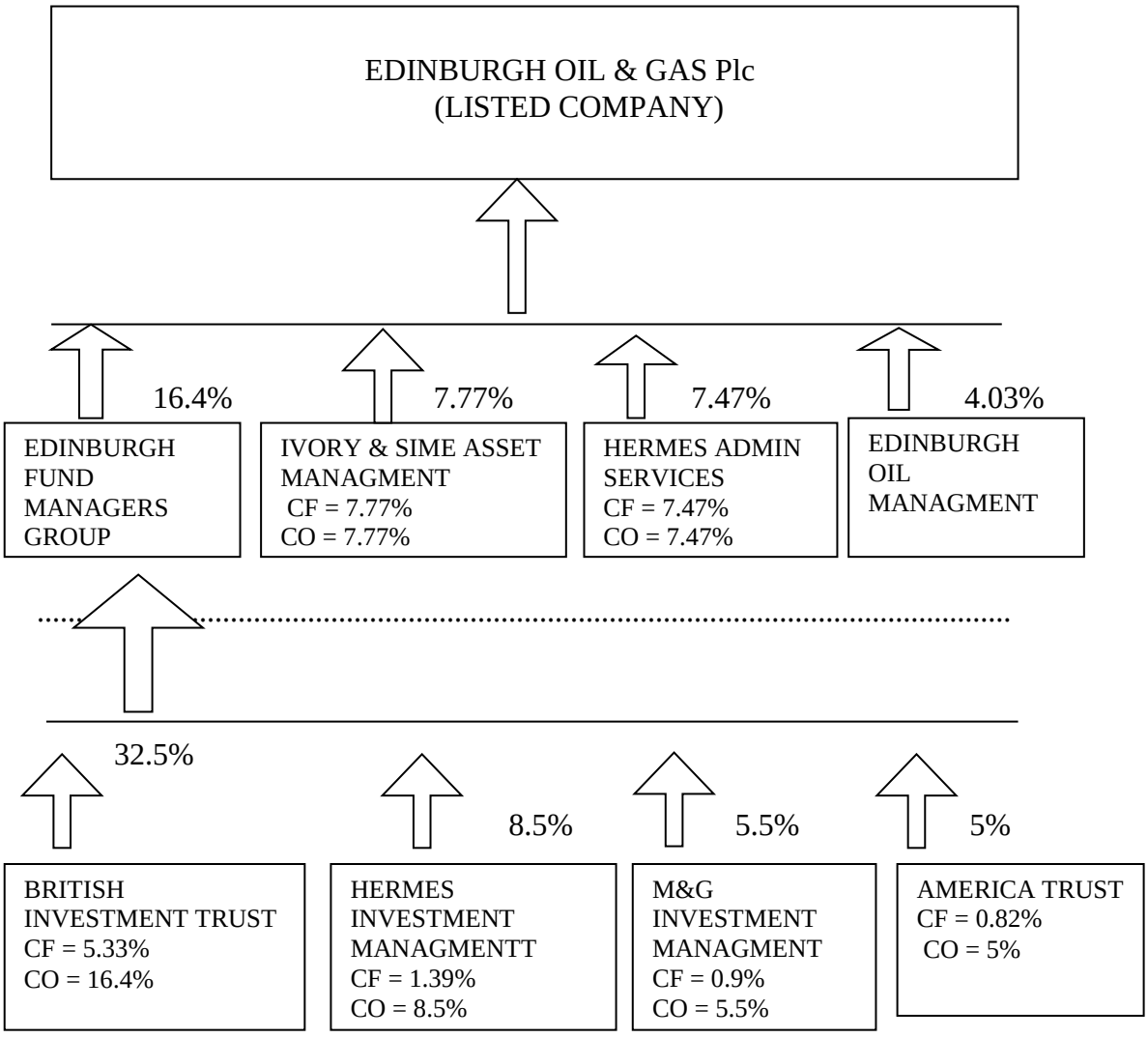
concerned, firm Y is said to be controlled through a pyramid at a certain cut-off level if it has an ultimate shareholder who controls it indirectly through another corporation (or more) that he/she does not wholly control with respect to the chosen cut-off level.

A UK context example of Edinburgh Oil & Gas plc is hereby presented for illustration purpose in Figure 4.1. Alongside the chain of control, the total shares cannot be summed up to 100, because the shareholders belong to different companies and not to the same company. They are linked to each other by ownership relationships and they are not independent as in the direct ownership dimension.

At a cut-off of 20%, Edinburgh Oil & Gas plc is defined as WIDELY HELD. When the cut-off is changed to 10%, British investment Trust is considered to be the first ultimate controller of Edinburgh Oil & Gas plc through Edinburgh Fund Managers Group with: Cash Flow rights (CF) =16.4%*32.5%=5.33% and Control Rights (CO) =min (16.4, 32.5) =16.4%

If the cut off is further reduced to 5% Hermes Investment Management is the second ultimate controller of Edinburgh Oil & Gas plc through Edinburgh Fund Managers Group with CF=(8.5%*16.4%)=1.39% and CO=min(8.5%,16.4%)=8.5%; Ivory & Sime Asset Management is the third ultimate controller of Edinburgh Oil & Gas plc with CF=7.77% and CO=7.77%; Hermes Admin Services is the third ultimate controller of Edinburgh Oil & Gas plc with CF=7.47% and CO=7.47%; M&G Investment Mgmt is the fourth ultimate controller of Edinburgh Oil & Gas plc through Edinburgh Fund Managers Group with CF=(5.5 *16.4)=0.9% and CO=(16.4,5.5)=5.5%; America Trust is the fourth ultimate controller of Edinburgh Oil & Gas plc through Edinburgh Fund Managers Group with CF=(5*16.4)=0.82% and CO=min(16.4,5)=5%

Figure 4.1: Cut-off, cash flow rights and control rights. Edinburgh Oil & Gas plc 1998.



However, there might be possible limitations which may be encountered in the applications of this principle because there is no theoretical foundation for its use to measure ultimate owners' control rights. Furthermore, the use of threshold values above which owners' voting rights are regarded as giving control and below which they are not is inevitably arbitrary, and leads to counter-intuitive outcomes.

Another limitation of using the weakest-link principle in measuring control rights is that it is unclear how to incorporate multiple owners into the weakest-link principle when there are two or more ultimate owners in a control chain into the weakest-link principle. However, the

use of this principle in calculating control rights may not result into seriously misleading results as it is widely used by the popular studies in ownership structure which produce highly reputable results such as La Porta et al. (1999), Claessens et al. (2000), Claessens et al. (2002), and Faccio et al. (2001).

The study differentiates control-rights with cash flows rights and defines the two as defined by Faccio and Lang (2002);

Control-Largest equals the control-rights of the largest shareholder with control of 10% or more of the voting rights.

Control-2nd Larger equals the control-rights of the second largest shareholder with control of 10% or more of the voting rights.

The study also reports the direct and indirect cash-flow rights of each of the large shareholders. To compute the shareholder's total cash-flow rights all direct and indirect cash flows rights are summed up. As in control-rights cash-flow rights of the first two larger shareholders are defined as follows;

Cash-Flow-Largest equals the cash-flow rights of the largest shareholder with control of 10% or more of the voting rights.

Cash-Flow-2nd Larger equals the cash-flow rights of the second largest shareholder with control of 10% or more of the voting rights

Restricting the sample to only firms with controlling shareholder, the ratio of cash flow rights to control rights are calculated so as to measure how much control rights have deviated from cash flow rights. Such ratios are computed as follows;

CFR/CRR-1st equals the ratio of cash-flow rights to control-rights of the largest shareholder that has control of 10% or above of voting rights.

CFR/CRR-2nd equals the ratio of cash-flow rights to control-rights of the second largest shareholder that has control of 10% or above of voting rights.

Multiple Large Shareholders (MLS) and their Bargaining power measures

For the purpose of examining the impact of multiple large shareholders on firm value maximization process, the sample firms with multiple large shareholders is selected such that it comprises of the largest block holder with above 20% ownership and the second largest having at least 10% ownership. To be able to refine the bargaining power of Multiple Large Shareholders, reference is made to Wolfenzon (2000) who provides the argument that MLS are the better agents of efficient monitoring due to the size of their stakes which increases the contestability of the largest shareholders' control power. Also according to Zwiebel's (1995) argument, large voting stakes enable large shareholders to share control and private benefits.

Different proxies are employed to capture bargaining power of Multiple Large Shareholders. The first one is the power of the second largest shareholder relative to the largest using the ratio of their relatives shareholdings as adapted from Attig *et al.* (2009).The second is the difference between the largest and the second largest as adapted from Maury and Pajuste (2005) .Both of these measures are transformed into logarithms so as to take care of skewness as in Maury and Pajuste (2005).

4.2.3 Control Variables

The following table summarises control variables in this study as suggested from literatures.

Table 4.1 Summary table for control variables

VARIABLE	DEFINITION	ADAPTED FROM
Growth Opportunities	Three years Sales growth rate	Laeven and Levine (2008)
Free Cash Flows	Free cash flows scaled by total assets	Boone *et al.* (2007).
Leverage	Book value of all long-term liabilities divided by total assets	Maury and Pajuste (2005), Laeven and Levine (2008) Gugler and Yurtoglu (2003).
Firm size	The natural logarithm of total assets	Rajan and Zingales (1995) Maury and Pajuste (2005), Laeven and Levine (2008) and Yurtoglu (2003) and Farinha (2003)
Investment ratio	Ratio of capital expenditure to fixed assets	Bhattacharya and Grahams (2009) as in Short (1994)
Profitability	Measured as Return on Assets (ROA)	Jensen *et al.* (1992) and Fama and French (2001)
Volatility	Standard Deviation of Share prices	Jensen *et al.* (1992) and Fama and French (2001)

4.3 Sample Distribution and Descriptive Statistics

4.3.1 Sample Distribution

4.3.1.1 Ownership Characteristics

Table 4.2 shows distinguished ownership structure based on shareholders' voting rights. An owner is said to be ultimate if he/she owns over 20% of company's direct or indirect voting rights. The alternative cut off of 10% is also conventionally used in literature because both provide significant thresholds of votes (La Porta *et al.* (1999) and Faccio and Lang (2002).

If a company has no shareholder holding more than 20% of equity ownership, it is classified as a widely held company. In their recent study on complex ownership and valuation, like in this study, Laeven and Levine (2008) adapting Faccio and Lang (2002) data, use this ownership classification. The types of ultimate share owners in this study are defined as in Faccio and Lang (2002) as follows;

Family: A family (including an individual) or a firm which is not listed on any stock exchange.

Widely held financial institutions: A financial firm which is widely held at the 20%, 10% or 5% control threshold

Widely held firms: Firms that do not have a shareholder controlling at least 20% of votes

Table 4.2 reports that, about 46.7% of sample firms used in this study are firms controlled by ultimately held companies at 10% threshold while 53.3% of all firms are firms owned by widely held companies at 10% threshold.

Table 4.2: Ownership characteristics

Number of companies with Widely Held owners at 5% threshold	*Number of companies with Ultimate owners at 5% threshold*
343	300

4.3.1.2 Sample Distribution Based on Block holders' Types

Table 4.3 presents the distribution of shareholders' types at 10% threshold.

The table shows that, 24.7% companies with ultimate ownership at 10% threshold are controlled by widely held financial institutions and 64.7 % by family firms. The table also reports that 10.6% represents other shareholders apart from family companies and financial institutions.

Table 4.3: Sample Distribution based on shareholders' types

	Number of Companies with Ultimate Ownership		
Type of shareholder	*Financial Institutions*	*Family Companies*	*Others*
At 10% threshold	74	194	32

4.3.1.3 Distribution of Control Structures

Furthermore, table 4.4 shows that, 45.6% of the sample firms have multiple large shareholders with the largest shareholder holding at least 20% of equity share and the second largest owning the minimum of 10% of the equity share as defined by Laeven and Levine (2008) and Faccio and Lang (2002) as in La Porta *et al.* (1999). Following Faccio and Lang, (2002), in this study a controlling shareholder is said to be "alone" if no other owner controls at least 10% (or 20%) of the voting rights. Table 4.4 reports that, 54.7% of the sample firms are firms with single controlling shareholder at 10% threshold.

Likewise, as in Faccio and Lang (2002), this study defines a pyramid firm as a firm with an ultimate owner who controls it indirectly through another corporation which it does not

wholly control. Further examination of control structures reveals that some companies have both pyramidal structure and dual-class equity structure. Table 4.4 shows that, while about 26% of the sample firms are considered to have dual-class equity structure about 31% have pyramidal structure. The table reports further that only 7% of the sample firms comprise of both pyramidal and dual share structure.

Table 4.4 Distribution of Control structure

Number of Companies with Multiple Large Shareholders	*Number of Companies with stand alone controlling Shareholder*	*Number of Companies controlled by pyramiding*	*Number of Companies controlled by dual-class equity closely held firms*	*Number Companies controlled by single class closely held firms*
291	352	198	170	321

4.3.1.4 Composition of Multiple Large Shareholders

Concerning the composition of multiple large shareholders, the study considers two major types of shareholders which form about 90% of the sample firms with multiple large shareholders namely family companies and widely held financial institutions. Table 4.5 shows that, only 6.4% of all companies having multiple large shareholders have both the largest shareholder and the second largest, financial institutions while 44.4% of all companies with multiple large shareholders have both the largest and second largest, family companies. On the other hand, while 21.6% of companies with multiple large shareholders have the largest shareholder a financial institution and the second largest a family company, 41.04% of companies with multiple large shareholders have the largest shareholder a family company and the second largest a financial institution.

Table 4.5 Composition of Multiple Large Shareholders

Number of Companies with Multiple Large Shareholders			
The largest is Financial institution & the second largest is also Financial institution	*The largest is Financial institution & the second largest is a family Company*	*The largest is Family company &the second largest is also family company*	*The largest is a family company & the second largest is a financial institutions*
17	58	119	110

4.3.1.5 Coalition and Control Sharing.

In an attempt to measure a control dilution, the study identifies firms whose largest owners control less than 50% of shares, hence, their control being diluted and no single shareholder possesses absolute control. Table 4.6 shows that, among companies with multiple large shareholders, 24% have the largest shareholder holding less than 50% of shares of the company such that there is no single shareholder with full control of the company. The table further shows that, about 75% of the companies have shareholders with full control. While about 53% of the sample firms with their control shared between two larger shareholders, 46.5% of the companies have their control shared by more than two larger shareholders.

Table 4.6 Coalition Formation and Control Sharing

Number of Companies with MLS and the largest owner has ownership greater than 50%	*Number of Companies with MLS and the largest owner has ownership less than 50%*	*Number of Companies whose control is shared by more than two larger shareholders*	*Number of Companies whose control is shared between first two larger shareholders*
48	150	106	93

4.3.2 Descriptive Statistics

4.3.2.1 Descriptive Statistics for Ownership Variables

Table 4.7 presents descriptive statistics on the concentration of control-rights and the separation of cash-flow rights and control by the largest immediate shareholders in UK listed companies. The analysis shows that in about 46% of sample firms there is a controlling shareholder with at least 20% of control-rights. In only 7% of the sample firms, a second controlling shareholder holds at least 20% of corporate control. The percentage for the control held by the second largest shareholders increases when the threshold is reduced to 10% in which case about 31% of the sample firms represents the second largest shareholders holding the corporate votes. The mean cash-flow rights of the largest shareholder read about 23% and its corresponding median is only 16%.

It is further reported that the mean and median control-rights of the largest shareholders are 26% and 19% respectively. While the mean and median of cash-flow rights of the ultimate largest shareholder are around 17% and 11% respectively, ultimate largest shareholders have control-rights having average of 24% and median of about 17%. The table also reports that, the second largest shareholders have mean cash-flow rights of about 16% and median of 14% while the control-rights of the second largest shareholders are recorded to have mean value of around 16% and median of about 15%. It is observed that ownership and control separation is higher for the first two largest shareholders and in contrast the third largest shareholder uses control in excess of cash-flow rights less frequently. This suggests that the two first largest shareholders hold entire control-rights whereas the third shareholder plays a more inactive role. Table 4.7 also discloses the use of dual-class equity by the controlling shareholders. It is documented that the two largest shareholders hold control-rights in excess of cash-flow rights. The controlling shareholder often chooses to use high-voting shares to strengthen her control. It is reported that on average the controlling largest shareholders and ultimate

controlling shareholders have the cash flow-control-rights ratio of 0.85 and 0.63 respectively while their corresponding medians are 1 and 0.73 respectively.

The table finally reports the mean and median of the ratio for the second largest shareholders to be 0.97 and 1 respectively.

Table 4.7 Descriptive Statistics on Ownership in UK.

This table reports the percentage of firms with controlling shareholders (1st and 2nd largest), the average percentage of votes and cash-flow rights by the largest owner, and the ownership/control ratio measured by amount of cash flow ownership/votes by the two largest owners respectively. The sample consists of 643 UK listed firms in LSE.

Panel A: Control concentration		***%***	***OBS.***
Percentage of firms with >20% control-rights held by the largest owner		*46*	*643*
Percentage of firms with >20% control-rights held by the 2nd largest owner		*7*	*643*
Percentage of firms with >10% control-rights held by the 2nd largest owner		*31*	*643*
Panel B: Controlling shareholders' control and cash-flow stakes	***Mean (%)***	***Median (%)***	
Cash-flow rights by the largest owner	*23.08*	*16.25*	*643*
Control-rights by the largest shareholder	*26.03*	*18.88*	*643*
Cash-flow rights by largest ultimate owner	*16.85*	*10.61*	*643*
Control-rights by the largest ultimate shareholder	*24.24*	*16.58*	*643*
2nd largest owner's Cash-flow rights	*15.59*	*14.39*	*643*
2nd largest owner's Control-rights	*16.15*	*14.59*	*643*
Panel C: Cash-flow rights-to-control-rights ratios	***Mean***	***Median***	
Largest controlling shareholder's cash-flow rights/control-rights ratio	*0.85*	*1*	*643*
Largest ultimate controlling shareholder's cash-flow /control-rights	*0.63*	*0.73*	*643*
2nd largest shareholder's cash-flow rights/control-rights ratio	*0.97*	*1*	*643*

Table 4.8 reports the number of firms in which the controlling shareholder use votes in excess of and equal to their cash-flow rights. In about 40% of firms the total sample the control-

rights of the largest shareholder deviate from her cash-flow rights in which cases high voting shares are used to increase control. It can be observed that, there is a significantly larger separation of ownership and control for the largest and the second largest shareholder. When the mean difference of the cash flow-control rights ratio between the largest and second largest is tested, it was realized that the difference are statistically significant at 1% significant level as depicted in table 4.8, panel B.

Table 4.8 also shows that, about 60% of the sample firms do not separate the ownership and control and therefore their cash flow-control ratio is unit. When considering the second largest shareholders, the table in panel A reports that, about 25% of the companies with second largest owners do not separate their ownership and control while only 18.5% have their control-rights greater than their corresponding cash-flow rights.

Table 4.8 Separation of Ownership and Control

This table reports the number (and percent) of firms where the 1st and the 2nd largest owner has cash-flow rights to-control-rights (CF/CR) ratios equal to one and less than one in Panel A. Tests of mean difference in the use of dual-class equity to enhance control by the largest and second largest shareholders are reported in Panel B.

Panel A: Largest shareholders' use of dual-class equity	Largest owner	2nd owner
Number (%) of CF/CR=1 firms	*388(60.3%)*	*163(25.3%)*
Number (%) of CF/CR <1 firms	*255(39.7%)*	*37(18.5%)*
Panel B: Tests of mean difference in (CF/CR) ratios between Largest owner and second largest (t-statistics)		
Largest owner vs. Second largest owner	***-2.37******	

, **, * Significant at the 10, 5, and 1 percent levels, respectively.*

4.3.2.2 Descriptive Statistics for Firm Characteristics and Univariance Analysis

Table 4.9 below presents the descriptive statistics for firm characteristics. It is shown that Tobin's Q of corporate firms in the UK is 1.89. This figure is slightly lower than that reported in Davies et al (2005) with Q=1.96 and Renneboog and Trojanowski (2007) with Q=2.12. However, it is substantially less than the mean of 2.47 reported by Doukas et al. (2002) and is relatively similar to the mean value of 1.86 that Short and Keasey (1999) report for their market valuation ratio.

On the other hand, table 4.9 reports debt value with mean of 0.16.This figure is a little more higher than that reported in previous UK studies such as Bevan & Danbolt, (2002) with mean=0.11 and closely similar to the one reported by Doukas et al. (2002) having mean value of 16.97.

Furthermore, the table reports the mean dividend payout ratio of 0.27. This figure closely compares with the one reported by Renneboog and Trojanowski (2007) which reports a mean dividend payout ratio of 0.36. Renneboog and Trojanowski (2007) report the pattern of UK dividends policy in 1990S.The figures used to compare in this study are only those for 1996-1998, although they use figures from 1992-1998. The average firm size is reported to be 4.54 in this study. This figure is higher than 12.2 reported by Renneboog and Trojanowski (2007).

The profitability averages to 0.059 a figure that almost coincides with that reported by Renneboog and Trojanowski (2007) with the value of 0.082. The mean Sales growth rate of this study is 0.154 .This is fairly higher than the one reported by Renneboog and Trojanowski (2007) having the value of 0.082.

Table 4.9. A Descriptive Statistics of firm characteristics

VARIABLES	***Observations***	***Mean***	***STD.DEV***	***Minimum***	***Maximum***
Performance (Q)	643	1.89	2.13	0.03	9.87
Dividend Payout	643	28	24	0	96.97
Leverage	643	16	18	0	93.99
Size	643	4.54	2.13	.149	12.62
Volatility	643	7.76	5.76	1	90
Profitability	643	5.88	15.52	-131.35	55.97
Investment Ratio	643	7.53	10.39	0	87.17
Free Cash Flows	643	2.63	157.59	-1305	2104.16
Growth	643	15.41	26.02	-48.76	379.63

The section further analyses the debt, dividend and performance mean difference between companies with multiple large shareholders against single controlling shareholders. The analysis in Table 4.10 shows that firms with multiple large shareholders have far more better performance as compared to firms with the single controlling shareholders. The performance difference of these two groups of companies is statistically significant at 1% significant level. This performance difference may be associated with the monitoring the second largest shareholders impose on the largest shareholder in companies with multiple large shareholders in an attempt to protect the rights of the minority shareholders.

With reference to agency theory, dividend policy and debt are used as mechanisms to limit the insiders from extracting private benefits. It is derived from Jensen (1986) free cash flow hypothesis that, to prevent insiders from misusing corporate excess cash flows, insiders should be forced to use the available cash flows to issue debt or to distribute the cash as

dividends instead of retaining it. However, debt may also be used by controlling shareholders as the tool to expropriate minority shareholders. Controlling shareholders, if not well monitored, may advance more debt to fulfil their private interest by engaging in projects which do not benefit the rest of shareholders and this may cost the whole company if the projects back fire because the company may run bankrupt. Therefore, controlling shareholders which are less monitored may use more debt than those well monitored.

Companies with multiple large shareholders limit the power of the largest shareholders by using the monitoring power of the second largest shareholders and other larger shareholders as compared to those with only single controlling shareholders. Hence companies with multiple large shareholders use more debt than companies with single controlling shareholders. This fact is proven in Table 4.10.The table reveals that, companies with single controlling shareholders use more debt in their capital structure than those companies with multiple large shareholders and the mean difference of leverage being marginally statistically significant at 5% significant level.

As far as dividends is concerned, controlling shareholders whose power is less limited may not opt in paying dividends instead they may plough back corporate free cash flows and misappropriate it compared to controlling shareholders whose power is monitored by other large shareholders. This has been revealed in our analysis and results are presented in Table 4.10.The results from Table 4.10 depict that, companies with multiple large shareholders have higher payout ratios as compared to those companies with only one controlling shareholder. The difference in dividend payout ratios between these two groups of corporations is statistically tested and found to be significant at 10% significant level. This shows that the presence of the second largest shareholders in companies with multiple large shareholders limits the ability of the largest shareholders to retain corporate excess cash flows

for their self-benefits not shared among other shareholders instead of distributing such cash as dividends.

After analysing companies with multiple large shareholders and those with single controlling shareholders, companies with dispersed ownership and companies with concentrated ownership are examined and results are presented in Table 4.10. Analysis from Table 4.10 depicts that companies with dispersed ownership are reported to have better performance than those companies with concentrated ownership. The test of statistical significance between performances means difference of the two categories show that the difference is statistically significant at 5% significant level. In an attempt to highlight the selfish behaviour of controlling shareholders in companies with concentrated ownership, the corporate leverage of both the companies with dispersed ownership and companies with concentrated ownership are also assessed. It is further reported that companies with concentrated shareholders use more debt in their capital structure than companies with dispersed ownership. Table 4.10 shows that, debt ratios are higher in companies with concentrated ownership than those whose ownership is concentrated with difference statistically significant at 10% significant level. However, higher debt may result into corporate bankruptcy resulting into shareholders' capital loss.

Like in corporate leverage, the study also assesses the corporate dividend policy of both categories of companies. The similar Table 4.10 shows that, companies with dispersed ownership tend to pay more dividends as compared to companies having concentrated ownership. The table reveals that, the difference in dividends between the two categories of companies is fairly statistically significant at 10% significant level.

To get an insight on whether the level of ownership concentration matters, the sample of firms whose ownership is concentrated is split further into highly concentrated (companies

with ownership above median) and companies with low concentrated ownership (those with ownership concentration below median). Table 4.10 reports the results. The analysis shows that, the level of ownership concentration does not affect firm performance as there is no statistically difference in performance between companies with higher ownership concentration and those with lower ownership concentration. Both leverage and dividend payout ratios were also assessed in connection to the two levels of ownership concentration.

The results from Table 4.10 reveal that, at higher level of ownership concentration firms use more debt as opposed to at lower levels. When the difference in leverage between these levels is tested it was realised that the difference is significant at 5% significant level. This reminds us of the expropriation behaviours of controlling shareholders when their control becomes relatively higher compared to when their control power is lower.

Furthermore, when dividend payout ratio was examined for the two concentration levels, it is found that at lower level of ownership companies pay more dividends than at higher levels. The finding is presented in Table 4.10 where the difference in payout ratio between the two levels is statistically significant at 10% significant level. This shows that at lower level of ownership concentration the shareholders have incentive to pay more dividends but as the ownership becomes more concentrated controlling shareholders start expropriating the interests of minority shareholders.

Finally, to explore more complex control structures the sample is split into firms with one share one vote system and those whose ownership and control are separated. The divergence between control-rights and cash-flow rights creates strong incentives for the controlling owner to divert resources among different firms. It is further noted that, controlling shareholders of firms which separate ownership from control such as pyramidal firms may force their subsidiaries to raise more external debt, reorganising this via intercompany

transactions and finally facilitating deployment of corporate resources for their own preferred projects as previously suggested by Atanasov *et al.* (2009). However, according to the authors, the expected bankruptcy which is considered as the disciplinary mechanism for over-usage of debt is declined because controlling shareholders in pyramid firms have limited liabilities for insolvency of their subsidiaries and the loss of reputation is minimal due to the difficulty of holding them responsible because of the complexity of the control web. This might be the reason as to why such companies use more debt than one-share one-vote companies. Table 4.10 shows a statistically significant difference of mean debt between companies with separated ownership and control and one-share one-vote companies, the difference being significant at 10% significant level.

Furthermore, as an indication of shifting corporate resources corporations whose ownership and control are separated postpone paying dividends or do not pay at all and use the corporate excess cash to extract private benefits. Table 4.10 shows that, on average, one-share one vote companies pay more dividend than those whose ownership and control are separated. The table reports a statistically significant difference in mean dividends at 5% significant level.

Due to diversion of corporate resources, companies whose ownership and control are separated perform poorly as opposed to one-share one vote companies. Table 5.9 reveals that, the performance of the latter is greater than that of the former with the mean performance difference being significant at 1% significant level

Table 4.10 Statistical Significance Test of Performance, Dividends and Debt Ratios

This table shows statistical significance tests of difference in performance, leverage and dividends between companies with multiple large shareholders and companies with single controlling shareholder (***MLS VS SCS***), companies with concentrated ownership structure and those with dispersed ownership structure (***CONCENTRATED VS DISPERSED OWNERSHIP***), companies with lower ownership concentration (below mean) and those with higher ownership concentration (above mean) (***LOWER VS HIGHER OWNERSHIP CONC***) and the companies with one-share one-vote system with those whose cash flow and control are separated (***ONE-SHARE-ONE VOTE VS SEPARATED CFR AND CR).*** **, **, *** Significant at the 10, 5, and 1 percent levels, respectively.*

Variable	*MLS VS SCS*	*CONCENTRATED VS DISPERSED OWNERSHIP*	*LOWER VS HIGHER OWNERSHIP CONC.*	*ONE-SHARE-ONE VOTE VS SEPARATED CFR & CR*
Performance	8.797***	-2.171**	0.872	3.18***
Leverage	-1.899**	1.659*	-1.743*	-1.742*
Dividends	1.526*	-1.621*	2.341**	1.95**

4.4.1.3 Correlations among Independent Variables

To test the correlations among independent variables, a pair-wise correlation table for all variables is created as presented in table 4.13. It is shown that, dividend payout ratio is negatively correlated with control-ownership wedge at 5% significant level with correlation of -0.128 and capital expenditure having a correlation of -0.183. The dividend payout ratio is also positively correlated with firm size (correlation= 0.248 leverage (correlation 0.135) both are statistically significant at 5%. It is also reported that profitability is positively correlated with firm size (correlation= 0.141), growth opportunities (correlation=0.108) and capital expenditures (correlation= 0.133).The profitability is also reported to be negatively correlated with risk (correlation= -0.174). All these are statistically significant at 5% significant level.

Leverage is reported to have a positive statistically significant correlation at 5% with cash-flow rights (correlation=0.097), control-rights (correlation= 0.098) and firm size (correlation=0.174). It is also shown that, leverage has a negative correlation with free cash flows (correlation= -0.126).

Another reported positive and statistically significant at 5% correlation is between performance and leverage (correlation=0.166) risk (correlation= 0.156), profitability (0.155) and capital expenditure (correlation=0. 217). The firm performance is also negatively correlated with size (correlation= 0.215) and control-ownership wedge (correlation =- 0.093)

The positive correlation between leverage firm performances shows that, contrary to Modigliani and Miller (1958), the capital structure is relevant as far as firm value is concerned. Another positive correlation between debt ratio and growth opportunities support of a contention that firms with more growth opportunities need more cash to explore such opportunities, hence they need to increase their cash base by borrowing. Likewise, a positive significant correlation observed between firm size and profitability does not come as a surprise as it is common that larger firms are more profitable due to size effect hypothesis. Larger firms have more assets to generate income hence more profitability.

The observed significant negative correlation between debt ratio and firm size is also associated with the understanding that, larger firms are more profitable and reputable in the debt market. Because they have stable profits and are less risky, their borrowing capacity is relatively higher. It therefore follows that they can have higher debt. This occurs only when there are more growth opportunities which cannot be explored using the available internal funds.

Furthermore, the negative correlation between volatility and firm size and volatility and profitability are concurrent with argument that, the larger firms are expected to be more profitable as they own larger base of assets which generate profits. It can therefore be argued that; the variations of returns (volatility) or rather profits in larger profitable firms are less severe than variations of returns in smaller companies. That is the suggested reason as to why there is a negative correlation between volatility and profitability, volatility and firm size.

Table 4.11 Correlation Coefficients Table of the variables used in the study

The table shows a correlation matrix of all variables used in the study of the relationship between dividends and ownership structure. *CFCR* is the control-ownership wedge of the largest shareholder (i.e. the shareholder with the largest control stake above 10%), CFR is the cash-flow rights of the largest shareholder, CRR is the control-rights of the largest shareholder, *SZ is* the natural logarithm of book value of total assets, *FCF* is the free cash flows scaled to total assets, *DT* is the ratio of total debt to total assets, *RSK* is the returns volatility or std deviations of the share prices, *GRT* is the three years average of sales growth rates, CPEX is the capital expenditure of fixed assets, *DPR* is the dividend payout ratio measured as dividends paid over net earnings, *ROA* is the returns on assets which is the EBIT scaled to total assets and Q is the performance measure defined as the market value of equity plus the book value of debt and preferred stock divided by the book value of assets *, reflect the statistical significance at 5%

	CFR	***CFCR***	***SZ***	***FCF***	***DT***	***RSK***	***GRT***	***CPEX***	***DPR***	***PROF***	***Q***
CFR	1.000										
CFCR	**0.428***	1.000									
SZ	-0.002	**-0.087***	1.000								
FCF	0.037	0.068	0.058	1.000							
DT	**0.097***	0.000	**0.174***	**-0.126***	1.000						
RSK	0.006	-0.022	**-0.126***	-0.020	0.053	1.000					
GRT	-0.007	0.037	0.038	0.032	**0.083***	-0.041	1.000				
CPEX	0.026	-0.002	**-0.104***	-0.034	-0.022	0.028	**0.106***	1.000			
DPR	0.022	**-0.128***	**0.248***	-0.041	**0.135***	0.009	-0.048	**-0.183***	1.000		
ROA	-0.019	-0.022	**0.141***	0.002	0.002	**-0.174***	**0.108***	**0.133***	**0.258***	1.000	
Q	-0.004	**-0.093***	**-0.215***	-0.003	**0.166***	**0.156***	0.001	**0.217***	-0.07	**-0.155***	1.000

4.4.1.4 OLS Model and Specifications Test

This study employs the Ordinary Least Square regression estimation method to determine the linear relationship between dependent and independent variables. To ensure that the OLS models are correctly specified some model specification tests are run to ensure that all appropriate variables are included and/ or omitted in the model. The significance of this test is as follows; first, to avoid inflating error term because if the relevant variables are omitted in the model the common variance they share with the remaining variables in the model may be wrongly attributed to the wrongly included variables.

Secondly, if the irrelevant variables are included in the model the commonly shared variance among the rest of variables in the model with the irrelevant variables included would wrongly be attributed to the irrelevant. These problems resulted from the model specification would significantly affect the estimated regression coefficients.

One of the suggested methods of dealing with detecting the specification errors is by employing the predicted values and their squares, regressing them on the dependent variable as predictors and checking their statistical significance. A well specified model will have no additional significant predictor variable. This test is performed in STATA using command *"linktest"*. The post estimation results of this test in this study for dividend model, leverage model and performance model as reported in table 4.15 show, in every case, that the predicted values variables **(_hat)** is statistically significant indicating that there is no model specification error while the square terms of all the predicted values variables **(_hatsq)** has no explanatory power and statistically insignificant as expected. These results reveal that our models are specified correctly and no irrelevant variable is included in the model.

However, another test known as Ramsey RESET specification test is run to test whether there are important variables which are omitted from the model. The test creates new variables based on the predictors and refits the model employing new variables and test the statistical significance of any of them. When this test is run in our study the results reported in tables 4.16 for dividend model, leverage model and performance model respectively show that, the F-test for each model is statistically insignificant to accept the null hypothesis of no omitted variables. This indicates that there are no specification errors and no important variable in the model is reported to be omitted.

Table 4.12 Linktest for Dividend Model specification, Debt Model Specification and Performance Model Specification (Test of irrelevant variables included)

	Performance Model	*Debt Model*	*Dividend Model*
_hat	2.337**(2.35)	1.178*(1.74)	1.861**(1.99)
_hatsq	-0.022(01.36)	-0.005 (-0.27)	-0.014 (-0.93)

Table 4.13. Ramsey RESET test of ommitted variables for Dividend Model, Debt Model and Performance Model (Test of relevant variables Ommitted).

Note: F (3, 581) stands for F-test for performance model, F (3,578) stands for F-test for debt model and F (3,581) stands for F-test for dividend model

Ramsey RESET test of omitted variables		
Variables used in Models of:	F (3, 581), F (3,578), F (3,581)	Prob> F
Performance	1.99	0.1145
Debt	0.29	0.8323
Dividend	1.48	0.2184

CHAPTER FIVE

5.0 OWNERSHIP, CONTROL STRUCTURES AND DIVIDEND POLICY

5.1 Introduction

This chapter examines the influence of corporate ownership and control structures such as pyramidal structures, dual-class equity structures and multiple large shareholders on dividend policy employing the UK sample of 643 listed non-financial companies for the period 1996-1999 using OLS estimation method.

Most previous studies on corporate governance have predominantly considered the US and the UK as economies whose financial markets are well-regulated and where ownership structure of corporations operating in these markets is dispersed, ruling out the agency conflict in these economies being mostly between managers and shareholders (La Porta *et al.* 1998). The agency conflict between managers and shareholders, according to Berle and Means (1932) and Jensen and Meckling (1976), arises because managers have their own interests which do not align with the interests of corporate owners. According to Jensen (1986), firms with substantial free cash flow are expected to have higher agency costs. The existence of free cash flow can tempt managers to use this fund in unprofitable projects and expropriate the interests of shareholders.

One of the mechanisms to control the misuse of such excess cash is returning the cash to shareholders in the form of dividends. Supporting Jensen (1986), Easterbrook (1984) considers dividend payments as a controlling tool for equity agency problems. According to Easterbrook, when the firm increases dividend payouts it may improve its reputation in the stock market among potential investors and hence reduces the agency costs. Dividends play an important role in limiting divergence of corporate assets by insiders. According to La

Porta *et al.* (2000), higher dividends are paid by companies in countries whose legal shareholders' protection is strong -such as those countries with codes based on Common Law rather than Civil Law.

Currently, due to the increase in ownership concentration in Europe and the UK in particular, the dominant conflict is between controlling shareholders and minority shareholders.

As reported by Bebchuk *et al.* (2000), Wolfenzon (1999) and Claessens *et al.* (2002), corporations are subject to expropriation when they are affiliated to a group of other corporations, all control being on hands of the same shareholder. This is found to be true for about half the corporations in Western Europe as reported by Faccio and Lang, (2002). Therefore corporate wealth is at risk of misappropriation by those insiders who can engage in tunnelling activities such as setting unfair terms for intra-group transactions and transfers of assets and control stakes.

Contrary to the traditional understanding that the US and UK have a dispersed ownership structure, the results of a recent study by Laeven and Levine (2008) show that, in a sample of 689 listed companies in the UK almost 75% of the sample was made up of companies with either multiple large shareholders or those with one large shareholder. Likewise, Marchica and Mura (2005), report a decreasing trend of widely held firms over time and they confirm that complex ownership structures in the UK are becoming an increasingly common phenomenon. The authors show that more than 10% of firms in the period 1993-2001 are controlled through a complex structure and the degree of departure of control-rights from cash-flow rights is reported to be around 11% at 10% threshold.

These unusual findings, in the UK context, have given new merit to investigating whether and how complex ownership and control structures may be used to expropriate the interests of minority shareholders and the appropriate means of limiting this agency conflict between

minority and majority shareholders. The study relates the discrepancy between ownership and control with dividends. Similar to the methodology of Faccio and Lang (2002), the study uses the ratio of cash flow rights to control rights as a measure of the corporation's vulnerability to insider expropriation within a group of corporations. This is because the conceptual simplicity of this measure facilitates exposition and empirical analysis.

There are few studies in the UK investigating the relationship between ownership structure and dividend policy. The available studies in the UK such as, Short *et al.* (2002), Renneboog and Trojanowski (2007) and Farinha (2003) present a negative relationship between inside ownership and dividends. Likewise, the relationship between institutional ownership and dividends is not only limited but also contradictory as Short *et al.* (2002) present a positive relationship between institutional ownership and dividends while Renneboog and Trojanowski (2007) report a negative relationship. Furthermore, the previous studies do not deal with the control-mechanism structures such as ultimate ownership, multiple large shareholdings and pyramiding. Notably, all these studies deal with widely-held corporations where the predominant agency conflict is that between managers and external shareholders.

Using ownership and control structure data for 643 UK non-financial listed companies, derived from Faccio and Lang (2002), this study using both OLS and Tobit regression, reports evidence of rent extraction hypothesis for companies whose ownership and control are separated and efficient monitoring hypothesis for companies whose ownership and control are not separated.

As predicted, the ownership concentration of the largest shareholder potentially exerts a positive influence on dividend payout ratio. It is argued that, when the largest shareholder realizes that they will earn cash corresponding to their large proportion of share ownership, there will be no incentive for them to influence a cash retention decision in an attempt to

facilitate private benefits extraction. Consistent with this prediction, a survey of regression results shows a significantly positive coefficient of the share ownership of the largest shareholder against dividend payout ratio.

On the other hand, ownership-control deviation has been associated with the negative wealth effect by controlling shareholders instituting lower dividend payouts and employing private benefits extraction. The results show that, pyramiding and dual-class equity structures are the major control structures which facilitate separating ownership from control but the effect of dual-class equity structures is more pronounced than that of pyramidal structures.

This is tested by comparing the mean difference between the dispersion of ownership from control for companies using both structures, and the results show that the dispersion caused by dual-class equity structures is significantly larger than dispersion caused by pyramidal structures. This is also supported by the statistical significance of the respective regression coefficients of their control-ownership wedges. The regression results show that the negative relationship between the control-ownership wedge and payout ratio is more statistically significant for companies which use dual-class equity structures to separate corporate ownership from control compared to those companies whose controlling shareholders use pyramidal structures to accumulate control.

The study further investigates the role of the second largest shareholder in monitoring the control of the largest shareholder. Contrary to expectations, the regression results show that the second largest shareholder plays insignificant role in influencing the decisions of the largest shareholder.

Finally the study examines the impact of size and composition of the control coalition or controlling group. The regression results show that the size and composition of the control coalition do matter. In particular, it is confirmed that companies with control coalitions

comprised of more than two block holders pay more dividends than those companies whose controlling group comprises only two block holders. This concludes that, in coalitions with more than two block holders of different types, decisions involving misuse of corporate funds may not be easily carried out as it might be difficult to satisfy every member in a coalition where different members have different goals. Because some members expect more benefits than others, those members expecting lower returns are unlikely to support the decision. This disagreement is in favour of minority shareholders because if the idea of retaining money for private benefits extraction is rejected, then the cash is distributed as dividends. That might be the reason why in coalitions with many members, a decision to pay dividend is always to be expected unlike coalitions with only two block holders.

This chapter proceeds as follows; section 5.2 presents related literature and hypotheses developments followed by section 5.3 which concentrates on empirical analysis and results. While section 5.4 presents the sensitivity analysis of the study to check the consistency of the results presented, section 5.5 concludes the study.

5.2 Related Literature and Hypothesis Development

5.2.1 Direct Ownership and Corporate Dividend policy

Most previous studies on corporate ownership structure focus on the agency conflict between corporate managers and shareholders. There are currently numerous studies which have changed focus to the conflict between majority and minority shareholders. This conflict occurs when the controlling shareholders become selfish in sharing the returns on investments with their fellow non-controlling shareholders and instead want to extract private benefits at the latter's expense (Shleifer and Vishny, 1997). Some of the literature suggests ways in which controlling shareholders may utilize their control to expropriate the interests of minority shareholders. Among them, according to Johnson (2000), are transfer pricing to

other companies they own, using assets of the company as collateral for other companies they own, and inflated payments for intangibles such as patents, brand names and insurance.

These activities are detrimental to corporations and may result in the deterioration of a firm's value as reported by Claessens and Djankov (1999). The authors report that, at higher ownership concentration levels, where there is potential risk of expropriation by controlling shareholders, the firm value tends to decrease significantly. In Germany, majority-controlled firms extract private benefits at the expense of minority shareholders and therefore dividend payout reduction is associated with such expropriation as reported by Gugler and Yurtoglu (2003).This amounts to what the literature terms *divergence of interest hypothesis* as emphasised by Shleifer and Vishny (1997) namely that dominant shareholders extract private benefits from corporate resources using the control they have over the minority shareholders. This tends to deny the rights of minority shareholders to equally enjoy their share of corporate profits.

On the other hand, a second view articulated by Easterbrook (1984) and Jensen (1986) is that payment of dividend may be used as a substitute for shareholders monitoring because it prevents misuse of corporate excess cash flows by imposing a strict financial discipline on the corporate managers. Provided that larger shareholders are the ones to enforce the payment of dividends, it follows, therefore, that ownership concentration is associated with higher dividend payouts. This is referred to as *efficient monitoring hypothesis*.

According to efficient monitoring hypothesis, dividends play a crucial role in preventing controlling shareholders from extracting personal benefits and therefore reducing possible agency conflicts between minority and majority shareholders. Payment of dividends guarantees a pro-rata distribution to both minority and majority shareholders. This prevents the controlling shareholders from taking control of corporate wealth. Faccio *et al.* (2001) also

suggest that dividends can be used by the controlling shareholders to reduce the complaints from minority shareholders about expropriation of their interests. From these explanations it is therefore feasible to suggest that dividends act as a mechanism to control the potentially selfish behaviours of the controlling shareholders.

The presence of a large shareholder whose control is enough to take corporate decisions may harm the interests of other shareholders. In such a case the controlling shareholder may choose not to pay dividends instead, they may use the free cash flow to extract personal benefits not shared by other shareholders. Studies which test the relationship between the share ownership of the largest shareholder and dividends payout show mixed results.

A negative relationship between the shareholdings of the largest shareholder and dividend payout is reported by Maury and Pajuste (2002) in Finland, Gugler and Yurtoglu (2003) in Germany, Mancinelli and Ozkan (2006) in Italy, Renneboog and Szilagyi (2006) in the Netherlands and Renneboog and Trojanowski (2007) in the UK.

Using a sample drawn from 37 countries, Truog and Heaney (2007) report a positive relationship between ownership by the largest shareholder and dividend payouts. In a situation like this, the largest shareholder will have a greater incentive to make decisions on distributing corporate excess cash flows as dividends. The cash-flow rights of the largest shareholder have the potential to exert a positive influence on dividend payout ratio. The possible reason put forward is that, when the largest shareholder realizes that they earn cash in accordance with their large proportion of share ownership, there will be no incentive for them to influence a cash retention decision in an attempt to facilitate the extraction of private benefits. In line with this view, the following testable implication is established:

Hypothesis One

The cash-flow rights of the largest block holder is positively related to dividend payout ratio

5.2.2 Ultimate Ownership and Corporate Dividend policy

5.2.1.1 Separation of Ownership and Control

The conflict of interest between controlling shareholders and minority shareholders is more pronounced in majority-controlled firms than in firms where the largest shareholder does not control over 50% of company equity (Gugler and Yurtoglu, 2003). According to the authors, majority control allows the largest shareholder to use their own discretion to take key corporate financial decisions such as that of dividend payout.

The impact of control structures on dividend payout ratio is not straightforward. On the one hand, a negative effect of control structures on dividend payouts is expected which exacerbates the majority-minority shareholders conflict. This amounts to rent extraction hypothesis as described by La Porta *et al.* (2000). According to Gugler and Yurtoglu (2003) rent extraction is manifested by the reduction of dividends granted to small shareholders in systems where the potential for this expropriation is more likely.

On the other hand, according to Faccio *et al.* (2001), when rational investors predict expropriation from the corporations they own, they may demand higher dividends. This study examines which scenario dominates in the UK. Most studies in the UK do not consider the pyramiding control structure which is a common control mechanism for many companies in Europe and particularly in the UK, a fact disclosed by Faccio and Lang (2002). While pyramiding introduces a wedge between control rights and cash flow rights, shareholders receive dividends in proportion to their cash-flow rights and control is established based on their voting rights.

A deviation between cash-flow rights and control-rights opens up the incentive and the possibility for controlling shareholders to hunt for other forms of compensation besides pro-rata dividends. This deviation may have a potentially negative effect on minority investors although there may as well be a counter effect if rational investors predict expropriation and demand higher contribution in terms of dividends (Gugler and Yurtoglu, 2003). Since voting rights give controlling shareholders the power to take key corporate financial decisions, having more control-rights grants them a greater degree of control which is, relatively, more beneficial to them.

To enhance their degree of control without increasing their investment base, controlling shareholders sell to minority shareholders non-voting shares which carry cash-flow rights. The expropriation is more likely to occur for controlling shareholders with cash-flow rights smaller than control-rights and larger control wedge are said to be associated with lower dividend payments (Gugler and Yurtoglu, 2003).

Following the preceding arguments it is expected that, those controlling shareholders with smaller cash-flow rights would suggest lower dividend rates or not pay dividends at all so that they can use the available corporate excess cash flow to pursue personal benefits because their share of dividend is small in the case of cash flow distribution. It follows, therefore, that controlling shareholders pursue private interests less when their ownership stake is larger, an argument consistent with Claessens *et al.* (2002), La Porta *et al.* (2002), Laeven and Levine (2008) and Gompers *et al.* (2008). The facts that ownership structure in the UK is reported to be complex and the separation of ownership and control is a common phenomenon, and that larger deviation between control and ownership attracts misuse of corporate assets, one may therefore predict the following testable implication:

Hypothesis Two

Control-ownership wedge is negatively related to dividend payout ratio.

5.2.1.2 Ownership-Control Separation Mechanisms.

5.2.1.2.1 Dual-class equity Control Structure and Dividend Policy

Dual-class equity structure is one of the control tools which are used by controlling block holders to expropriate minority shareholders' interests. It can be seen from the literature that in dual-class equity closely held firms there is a separation between voting and cash-flow rights, frequently allowing management to control the voting rights while only having a small proportion of the cash-flow rights (Grossman and Hart, 1988; Masulis *et al.* 2009). With the control of the voting rights, management has the ability to choose governance characteristics to further entrench itself or help protect the rights of the minority investors.

Concentrated ownership and control in dual-class equity closely-held companies where there is a separation between corporate ownership and control is one of the sources of second-order agency costs, the conflict between majority and minority shareholders (Masulis *et al.*, 2009). It is found in studies such as that of Correia da Silva *et al.* (2004) that concentrated control in dual-class equity closely-held companies creates a potential extraction of private benefits by controlling shareholders at the expense of non-controlling shareholders because controlling shareholders have larger voting rights compared to cash-flow rights. Literature further contends that dual-class equity ownership structure weakens the alignment of interests among shareholders resulting in potential expropriation of non-controlling shareholders' interests (Grossman and Hart, 1988).

In extending this view, Bebchuk *et al.* (2000) contend that, the controlling shareholders in dual-class equity firms are entitled to only a portion of corporate distribution. However, the controlling shareholders extract private benefits by employing corporate assets because they

have control over them. It can therefore be implied that, controlling shareholders institute lower dividend payouts so as to retain distributable cash flows for their own benefits.

Furthermore, it is suggested in the literature that dual-class equity closely held firms are less likely to have independent boards and have lower levels of institutional ownership. The excess control held by the largest shareholder facilitates the extraction of private benefits in dual-class equity closely-held companies, hence such companies may not prefer paying dividends instead they retain corporate free cash flow for projects not beneficial to other shareholders (Gugler and Yurtoglu, 2003; Mincinelli and Ozkan, 2006).

This study puts forward the private benefit hypothesis which predicts that controlling shareholders may not be willing to pay more dividends or may completely refrain from paying and instead they might choose to retain the distributable cash flows and use this to explore their own projects which do not ultimately benefit the non-controlling shareholders.

Regardless of the requirement of the LSE listings, in more than 25% of the sample firms used in this study block holders' control and ownership are separated via dual-class structures. This suggests that, UK controlling shareholders might have been involved in allocating significantly lower voting rights to preference shares to accumulate more control which may possibly result in the reduction of corporate value through cutting dividends and using the distributable income for projects which interest them personally. It is from these arguments that the following hypothesis is advanced:

Hypothesis Three

The control-ownership wedge of the largest shareholder in dual-class equity closely-held companies is negatively related to dividend payout ratio

5.2.1.2.2 Pyramidal Control Structure and Dividend Policy

La Porta *et al.* (1999) define pyramidal ownership structure as a structure that displays a top-down chain of control. According to the author, in this control structure the ultimate shareholders are located at the apex followed below by successive layers of firms. Claessens *et al.* (2000) contend that, this pyramidal ownership structure results in separation of actual ownership and control in firms located at the lower end of the pyramid structure. This separation occurs because pyramid structures create more control over cash-flow rights for an ultimate owner further up the pyramid structure and this has an ultimately negative impact.

Literature suggests that, a role of pyramidal holding is created by market imperfections and incomplete contracts. More precisely, the main underlying principle which governs the issue of pyramidal ownership is the limited liabilities principle. According to limited liability principle, entrepreneurial loss is limited to the amount of capital committed to the enterprise (Thomadakis, 1992).The author argues that the limited liability creates an array of default options against these claims. This may ultimately affect the organizational forms of corporations. Because most projects undertaken by controlling shareholders create growth opportunities which are riskier, the value of such opportunities are expected to be greater on a stand-alone basis. It follows therefore that a controlling owner will allocate his wealth into different firms, and through an internal control process, mainly via pyramidal holdings. Indeed, there is a possibility for the controlling block holder to have a lock on control of a group of companies with only limited wealth invested in a single project.

Due to lower capital he has invested in the project, the controlling block holder will have a strong incentive to extract private benefits from different firms in the structure through what Johnson *et al.* (2000) refer to as tunnelling, such as high interest loans, transfer pricing, leasing of assets and many others.

If the ultimate owners are left unmonitored, they may easily carry out their expropriation activities. To limit the potential for such selfish behaviour several corporate governance mechanisms should be instituted. Among these mechanisms is the corporate dividend policy.

Dividends have a potential to limit insider expropriation because paying a dividend is beneficial to all shareholders and it prevents controlling shareholders from retaining corporate excess cash, a view previously pioneered by Jensen (1986) in his free cash flow hypothesis.

In their recent theoretical work Burkart and Panunzi (2006) argue that the potential for controlling owners to become involved in expropriation depends on the extent to which ownership is separated from control. The authors suggest that, controlling owners may increase their level of expropriation as their control-rights increases relative to their cash-flow rights.

It therefore follows that, with pyramids, for a given level of control-rights a lower control-ownership wedge generates larger incentives for the ultimate shareholder to engage in private benefits extraction.

In a sample of 1532 companies across 13 European countries, Faccio and Lang (2002) show that about 21% of UK companies use pyramidal structure, the proportion which is the highest among other 8 countries except for Norway (33.9%), Belgium (25%) and marginally Germany (22.9%). Following the facts that the pyramidal structures are among the control-enhancing mechanisms, the following testable implication is put forward:

Hypothesis Four

The control-ownership wedge of the largest shareholder in pyramidal firms is negatively related to dividend payout ratio

5.2.3 Multiple Large Shareholders and Corporate Dividend Policy

5.2.3.1 The Presence and Influence of Second largest Shareholder

Since the seminal work by Berne and Means (1932), several governance mechanisms in widely-held corporations have been suggested to protect companies from value destruction through monitoring from large shareholders and takeover threat. Most recently several researchers have shown the spotlight on the influence of multiple large shareholders on firm value through reducing the conflict of interest between majority shareholders and minority shareholders. Laeven and Levine (2008) studying the role of multiple large shareholders on firm value, using the sample of listed companies in 13 European countries, find that the presence of multiple large shareholders helps to monitor the largest shareholder because other shareholders - due to their significant stakes - can monitor the largest shareholder. This, as a result, protects the interest of the firm and increases firm value.

On the other hand, Attig *et al.* (2009) investigate the impact of large shareholders on the interaction between firm's value and free cash flow using a sample of 22 countries from East Asia and Western Europe, and find that the presence of multiple large shareholders reduces the agency cost of free cash flow.

There also exist single country studies on the influence of multiple large shareholders on firm value. Belot (2008), Gutieres and Pombo (2009) and Maury and Pajuste (2005) using sample of French, Colombian and Finish listed firms respectively all report the presence of multiple large shareholders and their positive effect on firm value. From previous studies it can be found that there exist multiple large shareholders in the UK despite the traditional belief that the UK and US have a traditionally dispersed ownership structure. In Laeven and Levine (2008) it is found that in a sample of 689 listed companies in UK 26.7% of firms have no

controlling owner, 42.8% have one controlling owner while 30.5% of the sample represents companies with multiple large shareholders.

According to La Porta *et al.* (1999) and Claessens *et al.* (2002), a firm is said to have multiple large shareholders if the largest shareholder owns more than 20% of the shares while the second largest owner owns at least 10% of all quoted shares. Therefore it is interesting to find out whether the presence of multiple large shareholders in UK has any influence on curbing the problem of expropriating the interests of minority shareholders such as preventing the misuse of corporate excess cash flows instead of distributing it as dividends.

Currently the researcher's attention is focused on the effect of other larger shareholders, apart from the largest shareholder, on monitoring the behaviour of the largest shareholder. Among the few studies which focus on the role of other shareholders in monitoring the largest shareholder are Faccio *et al.* (2000), Maury and Pajuste (2002) and Gugler and Yurtoglu (2003). In their study of Europe and Asia, Faccio *et al.* (2000) find that in the presence of multiple large shareholders dividend rates are higher in Europe and lower in Asia. This reflects the fact that dividend payments reduce the expropriation of minority shareholders in Europe but accelerate it in Asia. The results show that the controlling shareholders in Asia collude with other larger shareholders and share control to expropriate the interests of minority shareholders.

Using a Finnish sample, Maury and Pajustie (2002) find a negative relationship between the presence of other larger shareholders and the payout ratio. However, in the case of Germany, Gugler and Yurtoglu (2003) report a direct relationship between the shareholdings of the second largest owner and dividend payout ratio. These studies show that there are mixed results on the role of multiple large shareholders in the limiting of expropriation of minority shareholders as far as the utilization of corporate resources is concerned, particularly the

distribution of excess cash flows to shareholders in the form of dividends. An empirical investigation is therefore required to examine whether other larger shareholders limit the unfavourable selfish behaviours of the largest shareholders or collude with them to expropriate the interests of minority shareholders.

This study suggests that collusion occurs when the second largest shareholder has a potential benefit from the expropriation (when their cash-flow rights are lower) and monitoring of the largest shareholder role is properly carried out when their cash-flow rights are higher and therefore, benefit more from cash distributions. Unlike the previous studies which use the voting rights as the measure of control of the largest and second largest shareholders, this study uses the control-ownership wedge as a control measure. This is a superior measure of control as it takes into account the discrepancies between control and ownership. Therefore, the higher the discrepancy between ownership and control, the larger is the control power of the block holder. As the controlling power of the largest shareholder goes up, the largest shareholder will favour paying fewer dividends and retain the excess cash flows to maximise their own benefits in the absence of the monitoring from other block holders. The presence of the second largest responsible block holder may limit the ability of the largest shareholder to accomplish this mission. Therefore this study argues that, the presence of second largest shareholders increases the level of dividend payments hence improves the agency problem between majority shareholders and minority shareholders

Hypothesis Five

The control-ownership wedge of the second largest shareholder is expected to weaken the relationship between the voting power of the largest shareholder and the dividend payout ratio.

5.2.3.2 Control Coalition Formation and Dividend policy

Previous literature contends that the presence of multiple large shareholders is one of the ways to mitigate second-order agency costs, the conflict of interest between majority shareholders and minority shareholders. According to Gomes and Novaes (2005), Laeven and Levine (2008) and Maury and Pajuste (2005), unlike a single large controlling shareholder, multiple large shareholders, due to their number may not easily reach a consensus on the decision to extract private benefit, thus protecting the interests of minority shareholders such as receiving dividends as a reward for their investment**.**

Bennedsen and Wolfenzon (2000)'s model contends that, a single shareholder does not have enough power to control the firm and therefore these individuals need to combine their voting powers and in such a scenario before any decision is made all shareholders must agree on the matter in hand.

Bennedsen and Wolfenzon say that, large shareholders have an incentive to form a coalition because of the private benefits obtainable from the control power generated from such a coalition. According to them, a coalition is formed by combining voting rights of the large shareholders to form a controlling group with voting rights above 50%. It is noted from Bennedsen and Wolfenzon that, in most cases the coalition with the smallest cash-flow rights wins among others during its formation. Therefore, the controlling group/coalition will have incentive (small cash flows right) and capability (sufficient voting rights) of expropriating minority shareholders' interests. It can be recalled from Jensen and Meckling (1976) and Bennedsen and Wolfenzon (2000) that, a controlling shareholder, in this case a winning coalition group, does not feel a large reduction of cash flows resulted from the divergence of corporate resources. This is referred to as *ex-post bargaining theory* according to Gomes and Novaes (2005).

Agreements on some issues like policy change which may involve personal benefits to controlling shareholders becomes more difficult as the number of members of the coalition increases. This may happen because some members may benefit less from the deal hence they may not volunteer to accept a particular decision at the expense of the firm's efficiency even though it might be in the collective interest of most of the group members.

It can also be learned from a brief survey of UK ownership structure that, to form a controlling coalition of above 50%, several large shareholders have to aggregate their voting rights resulting in difficulty in agreeing on decisions to extract private gains. An example of such agreements might cover areas such as retaining money for some projects which are not beneficial to all shareholders or cutting down dividends. The presence of a good number of coalition members may make it difficult to reach consensus on a particular decision. Two members are suggested to easily agree on the decision but the more members involved the harder it is to reach the agreement. It can therefore be hypothesised that:

Hypothesis Six

The number of controlling shareholders forming a control coalition is positively related to dividend payout ratio.

5.3 Empirical Analysis and Results

5.3.1 Empirical Method

In this section the study examines the relationship between ownership and control structures and dividend payout ratio measured as a ratio of dividend paid and operating income using the sample of 643 UK non-financial listed companies between 1996-1999. The first stage is to investigate whether probability of a positive dividend payout is dependent on the size of stake the controlling investor is holding and the control-ownership wedge of the largest

investor. More specifically, I run two logistic regressions of the binary variable dividend payout ratio on either cash flow-rights of the largest controlling shareholder and control-ownership wedge.

The second stage is to consider dividend payout ratio as a continuous independent variable; hence the amount of dividends paid is taken into account. As the independent variable is truncated at zero, a Tobit regression is employed. In fact, almost 20% of the sample firms do not pay dividends. Literature suggests that OLS regression should be avoided in the analysis of the relationship between ownership structure and dividend policy because when a variable is censored as in our case, dividends, OLS provides inconsistent parameter estimates reflecting that the parameter estimates will be far from population parameters and more specifically estimates of coefficients may be biased towards zero (Long 1997, Brooks, 2008).

However, in this analysis, OLS results are also reported to test against claimed inconsistency and bias. Maury and Pajuste (2002) used both OLS and Tobit regressions to examine the relationship between payout policy and ownership structure and found that the results were free from biased and inconsistent parameters.

A model to estimate regressions on censored dependent variables like dividends developed by Tobin in 1958 is presented as follows:

$$DPR_{i,t} = \alpha + \beta_1 * OWN_{i,t} + \beta_2 * DT_{i,t} + \beta_3 * FSZ_{i,t} + \beta_4 * IR_{i,t} + \beta_5 * ROA_{i,t} + \beta_6 * FCF_{i,t} + \beta_8 * SGR_{i,t} + e_{it}$$

Where;

$DPR_{i,t}$ = Dividend payout Ratio

$ROA_{i,t}$=Profitability

$OWN_{i,t}$ =Ownership and control variables e.g %age of the share held by the Largest block-holder

$\mathbf{RSK_{i,t}}$ =Corporate return volatility

$\mathbf{FSZ_{i,t}}$ =Firm Size

$\mathbf{IR_{i,t}}$ =Investment Ratio

$\mathbf{DT_{i,t}}$ =Leverage

$\mathbf{FCF_{i,t-1}}$ =Free Cash Flows

$\mathbf{SGR_{i,t-1}}$ =Sales Growth Rates

e_{it} = An error term

However;

$$\mathbf{DPR_{i,t}} = \begin{cases} \mathbf{DPR^{*}_{i,t}} \ \mathbf{If} \ \ \mathbf{DPR^{*}_{i,t} > 0} \\ \mathbf{0} \qquad \mathbf{If} \ \ \mathbf{DPR^{*}_{i,t} <= 0} \end{cases}$$

The dependent variable in equation (1) is corporate cash flow distribution in terms of dividends measured as the ratio of dividends to earnings. Based on the literature, the proven firm characteristics which affect dividend policy include firm size, measured as log of total assets, financial leverage measured as the ratio of total debt to total assets, growth opportunity, measured as the three years sales growth rate, performance, measured as return on assets, free cash flow and investment ratio measured as the ratio of capital expenditure and fixed assets. All these firm characteristics are defined in table 4.1. The independent variable, "ownership" comprises cash-flow rights, control-rights, the ratio of cash flow and control-rights held by the largest and second largest block holders respectively.

If the private benefits extraction hypothesis holds true, debt should be negatively related to dividend payout ratio as debt is used to curb agency costs (Jensen, 1986).Following Farinha (2003), corporate growth is expected to be negatively related to dividend payout. Corporate business risks tend to affect the dividend policy because the increase in firm risk profile

jeopardizes the financing strategies of companies and therefore risk is expected to be negatively related to dividend payout. In addition the size of the company affects positively the payoutratio as larger firms will be expected to pay more dividends compared to smaller firms. Likewise, profitability will have a similar impact on dividend payout (Rajan and Zingales, 1995).

5.3.2 Empirical Results

5.3.2.1 The control of the largest shareholder and Corporate Dividend Policy

We start by testing whether the probability of a company to pay dividends is dependent on the size of ownership stakes of the largest shareholder and the control-ownership wedge. The logistic regressions were run and the coefficient estimates, z-statistics and marginal effects for the logit regressions are presented in Table 5.3. The results show that the coefficient of cash flow rights is positive and significant at 5% significant level while the coefficient of control-ownership wedge is negative and strongly significant at 1% significant level. I therefore conclude that the size of the controlling shareholder's cash flow rights and the wedge between controlling shareholder's control and cash flow rights affects the probability that the firm has a positive dividend payout.

Among the control variables size, free cash flow, growth opportunities and profitability are the most statistically significant predictors of dividend payout ratio. Overall, as size of the firm , profitability and free cash flows increases, probability of a positive dividend payout becomes larger and this probability decreases as the growth opportunities and leverage increases.

The second stage in this section concerns with actual payment of dividends. In the second stage of the analysis, the study starts by testing the mean and the distributions of the dividend payout ratio for companies with higher ownership concentration (cash-flow rights) are

different from firms with lower ownership concentration. The results presented in Table 5.1 show that, the difference in mean dividend payout ratio between companies with higher ownership concentration and those with lower ownership concentration is statistically insignificant.

To analyse the influence of free cash flow on dividends, the sample is sub-divided into firms with lower levels of free cash flow and firms with higher levels of free cash flow. The difference in dividend payout ratios between the two groups of companies is then tested. Table 5.1 reports that, firms with higher levels of free cash flow pay higher dividend ratio compared to those firms with a lower free cash flow level. The difference in dividend ratios between the two groups of companies is reported to be strongly statistically significant at 1% significant level. It is also reported that companies with a higher level of free cash flow are associated with higher values of the cash flow rights of the largest shareholders. A company with higher levels of free cash flow is more likely to be associated with the corporate value destruction if the largest controlling shareholder has lower cash-flow rights relative to their control-rights. The results in Table 5.1 show that, the difference in the cash-flow rights and control-rights of the largest shareholder is not statistically significant. Therefore, the largest shareholder has got no incentive to collude with managers to extract private benefits from the excess corporate cash flows. This is considered to be a possible reason why companies with higher free cash flow have higher dividend payout ratios.

Referring to the analysis in Table 5.1, it is reported that, the difference in dividend payout ratio between companies with higher cash-flow rights and control-rights is statistically insignificant. However, when the analysis involving free cash flow is done, the results show that the difference in dividend payout ratios between companies with high free cash flow level and higher cash-flow rights of the largest shareholder is strongly statistically significant.

It was predicted from literature that, the cash-flow rights of the largest shareholder would have a potential to exert a positive influence on dividend payout ratio. The reason put forward is that, when the largest shareholder realizes that they will benefit financially from their large proportion of share ownership, there will be no incentive for them to influence a cash retention decision in an attempt to facilitate private benefits. Consistent with this prediction, regression results from Table 5.2, model 1, show a significantly positive coefficient of the share ownership of the largest shareholder against dividend payout ratio. According to Table 5.2, model 1, the relationship between share ownership of the largest shareholder is positive and statistically significant at 10% significant level.

This finding implies that, effective monitoring by shareholders in the UK, where legal protection is relatively strong, is associated with higher dividend payouts. The results reported in this study are consistent with the results of a recent cross-country study conducted by Truog and Heaney (2007) which shows that, ownership by the largest shareholder is positively related to dividend payouts. Indeed, this seems to be convincing because the more cash-flow rights the largest shareholder holds, the more incentives they have to pay dividends. However, the results contradict several single-country studies such as Maury and Pajuste (2002), Gugler and Yurtoglu (2003), Mancinelli and Ozkan (2006), Renneboog and Szilagyi (2006) and Renneboog and Trojanowski (2007) which suggest a negative relationship.

The analysis also reports the predictable relationships between dividend payout and some commonly used firm characteristics, and the results are as expected. The findings in Table 5.2 show that, companies whose debt level is lower tend to pay more dividends. This is supported by the sign of the coefficient in the regression run to test the relationship between the control of the largest shareholder and the dividend payout ratio. The table reports that, the debt ratio

has a negative relationship with dividend payout ratio. This relationship is statistically significant at 10% significant level.

As expected, the company size and profitability both have positive coefficients reflecting the fact that they are positively related to the dividend payout ratio. The positive relationship between size and profitability and the dividend payout ratio is statistically significant at 10% and 1% significant levels respectively. This shows that companies of larger size are more likely to be more profitable and these companies have more potential to pay more dividends. These associations are consistent with the past studies such as Truong and Heaney (2007) and Fama and French (2001).

Furthermore, there is a positive and statistically significant relationship at 5% significant level between investment opportunities and dividend payout. However, contrary to the expectation of this study, the findings show that there is a negative significant relationship between dividend payout ratio and free cash flow.

5.3.2.2 Control-Ownership Deviation and Corporate Dividend Policy

In this analysis a preliminary test is run to test whether means of measures of dividends for companies with above-mean values of control-ownership wedge have statistical difference with those companies with below-mean values. The test shows that companies with higher control-ownership wedge have greater mean dividend payout ratio compared to companies with below-mean values of control-ownership wedge. The t-statistics show that, the difference in mean dividends between the two groups of companies is statistically significant at 5% significant level. This mean difference test preliminarily confirms that control attracts controlling shareholders to extract private benefits. Therefore; companies with below-mean control-ownership wedge pay less dividends and retain more cash for their private deals

while those companies with above-mean control-ownership wedge will have incentive to pay more dividends because of the incentives they have due to higher cash-flow rights they possess.

The study further presents the regression results between the control-ownership wedge, a measure of the largest block holders and the measures of dividends, dividend payout ratio and dividend yields. Table 5.2, model 2 reports a negative and statistically significant relationship at 5% significant level between control of the largest shareholder and the dividend payout ratio. The result supports the prediction of this study about the incentive and ability of the largest shareholder to extract private benefits by utilizing the corporate excess cash flows in projects of their interests which do not benefit other smaller shareholders.

The private benefit extraction theory suggests that, as the control-rights of the largest shareholder increases, relative to the cash-flow rights, the ratio goes down and the decrease in ratio implies lower incentive for paying dividends hence the level of dividends paid by the company decreases because the free cash flows has a potential of being misused by the controlling shareholders. These findings are consistent with the Germany study by Gugler and Yurtoglu (2003) and others like Claessens *et al.* (2002), La Porta *et al*. (2002), Laeven and Levine (2008) and Gompers *et al*. (2008).

Unlike Gugler and Yurtoglu (2003) and Farinha (2003), who show that dividend payouts are negatively associated with firm size, this study reports a positive relationship between dividend payout and size. The relationship is statistically significant at 1% significant level. This finding supports a size effect hypothesis which advocates that larger firms are more profitable and therefore can potentially pay more dividends. The size effect is supported by the statistically significant relationship at 5% significant level between profitability and

dividend payout. The findings are consistent with Truong and Heaney (2007) and Fama and French (2001) who measures profitability in a similar way (ROA) as in this study.

Similar to Farinha (2003) who uses average growth rate in total assets and Fama and French, (2001) using a similar measure, by employing the sales growth rate as a proxy for growth opportunities, this study indicates that growth has a negative impact on dividend payouts. Like Gugler and Yurtoglu (2003) and Jensen *et al.* (1992), financial leverage has a negative association with dividend payout although this study reports a negative statistically insignificant relationship between leverage and dividend payout.

This is a support of the claim that, companies with more growth opportunities will not pay more dividends as the internal funds of the company are targeted for exploring the investment opportunities. When an alternative measure of growth opportunities (capital expenditure as ratio of fixed assets) is used, the similar results are observed although the statistical significance level dropped to 5%.

While leverage has no relationship with dividend payout ratio, with dividend yield as dependent variable, leverage is reported to have a negative relationship with dividend yield as expected with the statistical significance at 5% significant level. Like in dividend payout ratio, profitability is positively related to dividend yield though the statistical significance is decreased. The positive relationship between profitability and dividend yield is statistically significant at 10% significant level. Further analysis reports that, free cash flow has no relationship with dividend yield reflecting that corporate excess cash flow does not dictate the distribution of cash to shareholder

5.3.2.3 Dual-class equity control structure and dividend policy

So as to get some preliminary effect of dual class equity control structure on corporate dividend policy, the study tests the statistical significance of difference in mean values of dividend payout ratio and dividend yield between companies with higher values of control-ownership wedge and those companies with lower values. The results in table 5.1 show that the mean dividend payout ratio for companies with larger control-ownership wedge is significantly greater than that of companies with lower values of control-ownership wedge. The t-statistics show that, the difference in mean dividends between the two groups of companies is statistically significant at 5% significant level. However, when dividend yield is used instead, the test did not appear robust. The mean difference between two groups of companies shows no statistical significance.

The t-test results support the suggestion that control attracts block holders to extract private benefits. Therefore companies with a lower control-ownership wedge have more potential to underpay minority shareholders their share of dividends so as to use the distributable income for their own benefits while those companies with a higher control-ownership wedge will have an incentive to pay more dividends because they benefit more by so doing as their cash-flow rights are reasonably higher.

To control for the possible effects of pertinent variables that might influence dividend payout, dividend payout ratio and dividend yield are regressed on voting wedge and other control variables. The control variables include size, measured as the log of total assets, book value of debt-to-total assets, free cash flow scaled to total assets, growth opportunities measured as three-year sales growth rate, profitability measured as returns on assets and investment ratio measured as the ratio of capital expenditures to fixed assets.

Further analysis involves Tobit regressions with dividend payout ratio. The results reported in Table 5.2 model 3 indicate that, voting wedge of dual-class equity firms is negatively related to dividend payout ratio. The relationship between control-ownership wedge and dividend payout ratio is statistically significant at 1% significant level. This finding is consistent with private benefits of control hypothesis as confirmed by Ozkan (2006).The results imply that the higher the deviation of cash flow from control-rights the lower dividends payout ratio because the controlling shareholders in dual-class equity firms would prefer retention of corporate excess cash flows so that they utilize it in their rent extraction programs.

The Tobit regression analysis further suggests that the size of the company is not related to dividend distribution of dual-class equity companies, but profitability is positively related to dividend payout ratio and the relationship is statistically significant at 1% significant level. Financial leverage is also statistically insignificant in explaining the dividend payout of the dual-class equity firms indicating that the increase in level of firm financial leverage has no impact on dividend payments; as expected the increase in level of debt decreases the level of dividends paid to the corporate shareholders.

A similar statistically insignificant relationship is also shown between the free cash flow and dividend payout ratio. This suggests that dual-class equity companies may not depend on free cash flow to pay dividends to their shareholders. However, growth opportunities measured by sales growth rate are noted to have a strong negative relationship with dividend yield as postulated before. The relationship is significant at 1% significant level as reported in Table 5.2, model 3. This is in support of the claim that companies with more growth opportunities will not pay more dividends as the internal funds of the company are targeted for exploring investment opportunities.

5.3.2.4 Pyramidal control structure and dividend policy

As in the case of dual-class equity firms, a test was run to see whether there is a statistical mean difference of dividend payout ratio between companies with higher values of control-ownership wedge and those companies with lower values in pyramidal firms. The results show that the mean dividend payout ratio for companies with higher control-ownership wedge is significantly greater than that of companies with lower values of control-ownership wedge - by about 30%.The t-statistics show that the difference in mean dividend payout ratio between the two groups of companies is statistically significant at 1% significant level. This evidence is reported in table 5.1.

When comparing the statistical difference in terms of dividends between dual-class equity companies and pyramidal firms without considering the level of control-ownership wedge, one can note that mean dividends in pyramidal companies are greater than in dual-class-equity companies and the difference is reported to be statistically significant at 5% significant level as reported in table 6.1. It is also shown that the mean control-ownership wedge in dual-class equity companies is lower than in pyramidal companies. This may indicate that the use of dual-class equity structure in separating cash flow rights from control rights imposes more effect on value reduction than employing pyramidal structures.

Dividend payments in pyramidal firms are also examined using regression analysis. The regression results from Table 5.2, model 4 shows that the control-ownership wedge of pyramidal firms negatively relates to dividend payout ratio. This relationship is statistically significant at 5% significant level. Table 5.2 further shows the relationship between dividend payout ratios with firm characteristics. The results show that size and profitability are the key factors which influence positively dividend payout ratio with statistical significance at 1%

and 5% significant level respectively. Unlike in dual-class equity firms where leverage does not affect dividend payout, in pyramid firms leverage is positively related to dividend payout ratio and the relationship is statistically significant at 10% significant level.

A statistically insignificant relationship is depicted between the free cash flow and dividend payout ratio as in dual-class equity firms. The results in Table 5.2, model 4 further shows that growth opportunities, measured by sales growth rate, are negatively related to dividend payout ratio and strongly statistically significant at 1% significant level. This supports the suggestion that growth opportunities attract excess corporate cash flows which would otherwise be used to pay dividends.

5.3.2.5 The Presence and Role of the Second largest Shareholder

The analysis further presents the empirical results on the common contention that the presence of the second largest shareholder in a company may either limit the selfish behaviour of the largest shareholder by active monitoring, or facilitate it by colluding with them to extract private benefits. To test this hypothesis a regression is run first to include only the control of the largest shareholder to examine the impact of this control on the dividend payments to the minority shareholders using the sample firms with multiple larger shareholders where the largest shareholder holds at least 20% of the corporate shares and second largest at least 10%.

The first task is to test the dividends mean difference between the companies with above and below mean control-ownership wedge for companies with second largest shareholders. Table 6.1 shows that the dividend payout ratios mean difference between the two groups of companies is statistically different at 1% significant level. It is noticed that companies with a

higher control-ownership wedge pay more dividend (30% higher) compared to those companies whose mean control-ownership wedge is below the average.

Tobit regressions are run to test the relationship between the control-ownership wedge of the first two largest shareholders and dividend payout ratio. The results are summarised in Table 5.2, model 5. It is expected that either the presence of the second largest shareholder will reduce the extraction of private benefits by the largest shareholders or will, through collusion with them, expropriate more the interest of minority shareholders.

The results reported in Table 5.2, model 5 surprisingly report a statistically insignificant positive relationship between the control-ownership wedge of the largest shareholder and dividend payout ratio - contrary to the rent extraction hypothesis put forward. To test whether the presence of the second largest shareholder has an impact on the control of the largest shareholder, a regression which includes both the control-ownership wedge of the largest and second largest shareholders is run. The results in Table 5.2, model 6 show that when the control-ownership wedge of the second largest shareholder is introduced into the original model it is observed that there is still a statistically insignificant relationship between the largest shareholder's control-ownership wedges. These findings are inconsistent with the monitoring role of the second largest shareholder as proposed by Faccio *et al.* (2001) for Europe and Gugler and Yurtoglu (2003) for German companies.

5.3.2.6 Number of Controlling Shareholders in a Controlling Group

To examine whether the number of shareholders in a controlling group formation matters in reaching consensus during decision making, the study splits the main sample into two groups: those company in which the stakes of the first two largest block holders add up to more than 50% and those in which the stakes of three or more holders are required to exceed 50%. The 50% figure is a threshold chosen because it is believed that holding above 50% grants members of the coalition a comfortable ability to make investments and financing decisions about the company without involving other shareholders.

Tobit regressions are run including control-ownership wedge and dividend payout ratio in the models. Model 7 and model 8 in Table 5.2 report the regression results for the relationship between control-ownership wedge of the largest shareholder and dividend payout ratio for companies with two block holders in a coalition and the second one with more than two block holders. It is shown that the relationship between control-wedge of the largest block holder in corporations with more than two coalition members is positively related to dividend payout ratio. This relationship is statistically significant at 5% significant level.

When the relationship between control-ownership wedge of the largest block holder and dividend payout ratio is examined, using a sample of companies with only two block holders-controlling groups, Table 5.2, model 8 reports a negative insignificant relationship. Both these results show that companies with control coalitions having more than two block holders pay more dividend than those companies whose controlling group consists of only two block holders.

This disagreement helps the minority shareholders, because if the idea of retaining money for private benefit extraction is rejected then the cash is distributed as dividends. That is the reason why in coalitions with many block holders, the decision to pay dividend is always to

be expected, compared to coalitions with only two block holders. This interpretation can further be extended to the following arguments: coalitions formed by only two block holders may reach agreement more easily, because in most cases, more than 50% in our sample, the coalition of this nature consists of two members' family companies or two widely held financial institutions. Since the two members of the same type can be assumed to know each other better and have similar philosophies, missions, objectives and goals they can easily conclude the deal. In less than 10% of all cases in our sample, members of controlling groups in companies with more than two coalition members are of the same type. This supports the contention that it is difficult to reach agreement in the decision-making process when the controlling group has many members and the members are not of the same type.

All firm characteristics except growth opportunities, free cash flow and profitability are statistically insignificant in both models. Table 5.2 model 7, using a sample of companies with more than two block holders in a coalition group, reports that, growth opportunities are negatively related to dividend payout ratio. The relationship is statistically significant at 1% significant level. The positive relationship between dividend payout ratio and profitability is also reported in the same model 7. The relationship is reported to be statistically significant at 5% significant level. The relationship between free cash flow and dividend payout ratio is reported to be positive and statistically significant at 5% significant level reflecting the fact that the more excess cash present, the higher will be the dividend payout ratio consistent with the free cash flow hypothesis advocated by Jensen (1986).

When the sample of companies with only two block holders in a control coalition is examined, the results show that there is a positive relationship between dividend payout ratio and profitability which is statistically significant at 10% significant level. In the same table, 6.2, model 8 the negative relationship between growth opportunity and dividend payout ratio is reported. The relationship is statistically significant at 5% significant level. Finally, Table

5.2 model 8 reports a negative and statistically significant, at 5% significant level, relationship between free cash flow and dividend payout ratio. This is contrary to Jensen's (1986) free cash flow hypothesis.

Table 5.1 Univariate Tests on the Dividend Payout

In this table, the mean values of the dividend payout variables DIVIDEND PAYOUT RATIO and DIVIDEND YIELD are compared using standard t-tests on means. Information from Worldscope and firms' annual reports for the period 1996-1999 is used to build the dividend payout variables. For a particular firm DIVIDEND PAYOUT RATIO is the ratio between the cash dividend payments divided by net earnings while DIVIDEND YIELD is defined as cash dividend scaled to market capitalization. The mean values of the dividend payouts variables for observations related to firms with controlling shareholders having higher control-ownership wedge are compared to the mean values of the same variables for observations of firms with controlling shareholders possessing lower control-ownership wedge (HCW VS. LCW), dual-class equity firms with controlling shareholders having higher control-ownership wedge are compared to the mean values of the same variables for observations of firms with controlling shareholders possessing lower control-ownership wedge (HCW-D VS. LCW-D), pyramidal firms with controlling shareholders having higher control-ownership wedge are compared to the mean values of the same variables for observations of firms with controlling shareholders possessing lower control-ownership wedge (HCW-P VS. LCW-P), firms with the second largest shareholder having higher control-ownership wedge are compared to the mean values of the same variables for observations of firms with second largest shareholder having lower control-ownership wedge (HCW-SLS VS. LCW-SLS) firms with controlling shareholders holding higher cash flow rights are compared to the mean values of the same variables for observations of firms with controlling shareholders having lower cash flow rights (HCFR VS. LCFR), firms with higher free cash flows values of the same variables for observations of firms lower free cash flow values (HFCF VS. LFCF). The variable is considered to be lower if its value falls below its mean and higher if it is above mean. *, ** and *** stand for statistically significant at 10%, 5% and 1% respectively.

VARIABLES	*HCFR VS. LCFR*	*HFCF VS. LFCF*	*HCW VS. LCW*	*HCW-D VS. LCW-D*	*HCW-P VS. LCW-P*	*HCW-SLS VS. LCW-SLS*	*DUAL-CLS VS PYRAMID*
Dividend Payout	1.34	2.71***	2.16**	1.64*	2.57***	3.18***	-2.17**
Dividend Yield	1.57	1.83**	2.26**	1.09	1.67*	0.76	-1.75*

Table 5.2 .Tobit Models: Ownership and Control Structures and Dividends

This table reports the estimates for Tobit regressions of the dependent variable DIVIDEND PAYOUT RATIO (dividends paid over Net Earnings) on several independent variables. The regressions are run on samples firms with controlling shareholders. The sample period is 1996-1999. The regressions include the cash-flow rights (CF-RIGHTS) ;MODEL 1, control-ownership wedge of the largest shareholders (CFCR); MODEL 2 , control-ownership wedge of the largest shareholders (CFCR) for dual-class equity firms; MODEL 3, control-ownership wedge of the largest shareholders (CFCR) for pyramidal firms; MODEL 4, only the control-rights of the largest shareholder(STCR); MODEL 5 ,both control-rights of the second largest shareholder (NDCR) and largest shareholders (STCR) for dual-class equity ; MODEL 6, control-ownership wedge of the largest shareholder for controlling group formed by more than two largest block holders in control coalition (CFCR);MODEL 7 and control-ownership wedge of the largest shareholders for controlling group formed by only the first two largest block holders in control coalition (CFCR);MODEL 8. The data necessary to build the variables is extracted from Thomson DataStream and WoldScope. The ownership variables are constructed from Faccio and Lang (2002) ownership database. For a particular firm, the variables *SIZE, FCF, GRTH, IR and PROF are* computed using information as of the end of the fiscal year one year after the year in which ownership variable is extracted. *SIZE is* the natural logarithm of book value of total assets, FCF is the free cash flows scaled to total assets, is the ratio of total debt to total assets, LEV is the ratio of total debt to total assets, GRTH is the three years average of sales growth rates, IR is the capital expenditure over fixed assets and ROA is the EBIT scaled to total assets. For each independent variable, the table shows the coefficient estimates and the t-statistic accompanied with *, **, or **** to reflect the statistical significance at 10%, 5% and 1% significant level respectively, and t-statistics in bracket. Industry dummies are included in the models and reported as INDUMMY.

DEPENDENT VARIABLE- DIVIDEND PAYOUT RATIO								
Variable	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
CF-RIGHTS	0.145*							
	(1.75)							
STCFCR					-0.064	-0.034		
					(-0.56)	(-0.30)		
NDCFCR						-0.500		
						(-1.44)		
CFCR		-11.913**	-22.058***	-14.324**			64.481**	-27.190
		(-2.44)	(-3.85)	(-2.23)			(2.16)	(-0.87)
SIZE	3.726*	3.878**	3.773	3.474***	3.261	3.236	2.7833	3.826
	(1.92)	(2.55)	(1.53)	(3.16)	(1.29)	(1.32)	(1.06)	(1.52)
FCF	-0.035***	0.020*	0.013	0.002	-0.021	-0.021	-0.003	-0.041**
	(-2.59)	(1.69)	(1.02)	(0.26)	(-1.28)	(-1.27)	(-0.21)	(-2.51)
LEV	-0.129*	0.031	0.158	-0.043*	0.012	0.002	-0.052	0.029
	(-1.86)	(-1.56)	(1.22)	(-1.64)	(0.11)	(0.02)	(-0.0515)	(0.28)
GRTH	-0.050	-0.313***	-0.2992***	-0.504***	-0.481***	-0.481***	-0.635***	-0.266**
	(-0.47)	(-3.84)	(-3.08)	(-4.80)	(-4.49)	(-4.65)	(-4.82)	(-2.32)
IR	0.319**	0.174	0.2808	-0.029	-0.237	-0.249	0.283	-0.135
	(2.24)	(0.62)	(1.22)	(-0.07)	(-1.21)	(-1.25)	(1.08)	(-0.63)
ROA	0.931***	0.615***	0.5723***	0.492**	0.757**	0.771**	0.719**	0.713*
	(2.93)	(2.64)	(2.73)	(2.38)	(2.39)	(2.45)	(2.49)	(1.92)
CONSTANT	-1.683	15.999	16.389	27.274***	17.425	24.533***	-40.754	3.192
	(-0.1)	(1.18)	(1.01)	(3.41)	(1.31)	(11.9)	(-1.34)	(0.9)
R^2/Pseudo R^2	0.04	0.03	0.05	0.06	0.04	0.04	0.06	0.03
F-stat	1.91*	8.16***	6.73***	16.7***	4.71***	4.2***	4.54***	2.99***
Log likelihood	-1195.717	-1026.489	-696.422	-495.788	-778.283	-777.238	-363.3487	-409.5842
INDUMMY	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	313	255	170	124	199	199	96	103

Table 5.3 .Logistic Model: Ownership and Control Structures and Dividends

This table reports the estimates for Logistic regressions of the dependent variable; binary variable=1 if DIVIDEND PAYOUT RATIO (dividends paid over Net Earnings) is greater than zero (companies which pay dividends) and 0 if DIVIDEND PAYOUT RATIO=0 (companies which do not pay dividends) on several independent variables. The regressions are run on samples firms with controlling shareholders. The sample period is 1996-1999. The regressions include the cash-flow rights (CF-RIGHTS), MODEL 1 and, control-ownership wedge of the largest shareholders (CFCR), MODEL 2. The data necessary to build the variables is extracted from Thomson DataStream and WoldScope. The ownership variables are constructed from Faccio and Lang (2002) ownership database. For a particular firm, the variables *SIZE, FCF,LEV, GRTH, VOLAT and PROF are* computed using information as of the end of the fiscal year one year after the year in which ownership variable is extracted. *SIZE is* the natural logarithm of book value of total assets, FCF is the free cash flows scaled to total assets, is the ratio of total debt to total assets, LEV is the ratio of total debt to total assets, GRTH is the three years average of sales growth rates, IR is the capital expenditure over fixed assets and ROA is the EBIT scaled to total assets. For each independent variable, the table shows the coefficient estimates and the t-statistic accompanied with *, **, or **** to reflect the statistical significance at 10%, 5% and 1% significant level respectively, and t-statistics in brackets. Industry dummies are included in the models and reported as INDUMMY

Dependent Variable: Binary Variable =1, If DPR>0 and 0 if DPR=0

Independent Variables	Model 1	Model 2
CF-RIGHTS	0.007*(1.84)	
CFCR		-0.994 *** (-2.77)
SIZE	0.6034***(5.60)	0.4032***(4.20)
FCF	0.0031***(7.70)	0.022***(3.40)
LEV	-0.0066**(-2.41)	-0.0023**(-2.11)
GRTH	-0.0065***(-2.95)	-0.0235*(-1.95)
IR	-0.000(-0.01)	0.032(0.05)
ROA	0.1562*(1.74)	0.1562*(1.87)
CONSTANT	0.2326(0.24)	0.1226(0.56)
R^2/Pseudo R^2	0.287	0.238
Wald Chi^2	248.32***	227.52***
Log likelihood	-223.62067	-221.1436
INDUMMY	Yes	Yes
Observations	642	642

5.4 Sensitivity Analysis

Although most studies on dividend payouts suggest OLS should be avoided when studying the relationship between ownership structure and dividend policy because its estimates are biased and inconsistent (Long, 1997; Brooks, 2008), this study presents OLS results parallel with Tobit regression results. The results for OLS are reported to be consistent throughout with those of Tobit regressions. The comparisons of the two methods are presented below:

It is surprising to find that, even when the relationship is insignificant, in some cases both methods show a similar regression positive or negative signs. In Table 5.4, model 1 the relationship between the ownership of the largest controlling shareholder and dividend payout ratio is tested and the relationship for both methods is positive and statistically significant at 10% significant level.

When the relationship between control-ownership wedge of the largest shareholder and dividend payout ratio is tested, the results in Table 5.4, model 2 and Table 5.2, model 2 show that OLS and Tobit regressions both report a negative and statistically significant relationship at 5% significant level. It is reported that for dual-class equity companies, wedge control of the largest shareholder is negatively related to dividend payout ratio. The relationship between control-ownership wedge and dividend payout ratio is statistically significant at 5% significant level for both methods.

As is the case in dual-class equity companies, similar and consistent results are observed when the relationship between the control-ownership wedge of the largest shareholder and dividend payout ratio is tested for pyramidal companies. Table 5.2, model 4, reports that, using Tobit regression, the relationship between control-ownership wedge of the largest controlling shareholder in pyramidal companies and dividend payout ratio is negatively related and statistically significant at 1% significant level. A similar negative, and statistically

significant at 1% significant level, relationship is also reported when OLS is employed in Table 5.4, model 4. The comparison between OLS and Tobit regression is also conducted for the role of second largest shareholder in reducing the selfish-behaviour of the largest shareholder. Table 5.4, model 5 and model 6 and Table 5.2, model 5 and model 6 report that the presence of the second largest shareholder has no role to play in preventing the largest shareholder from expropriating minority shareholders' interests. The relationship between the voting rights of the largest shareholder and dividend payout ratio, before introducing the voting rights of the second largest shareholder, is not statistically significant for either OLS or Tobit regressions. After including the voting rights of the second largest shareholder the relationship remains statistically insignificant proving that the presence of second largest shareholder has no impact for either regression method.

Finally, it is reported in Table 5.2, model 7 and model 8 and Table 5.4, model 7 and model 8 that, with the presence of only two block holders in a controlling group formation, the relationship between control-ownership wedge of the largest shareholder and dividend payout ratio is statistically significant for both OLS and Tobit regressions. The statistically significant relationship is observed between the control-ownership wedge of the largest shareholder and dividend payout ratio for a sample of companies whose controlling group is formed by more than two block holders. The relationship is reported to be positive and statistically significant at 5% significant level for both regression techniques. When the dividend yield is used as a dependent variable, repeating all regressions, instead of dividend payout ratio, the results remain qualitatively unchanged and in most cases the regression results for both dividend payout ratios and dividend yield showed a similar signs and same significance level.

Table 5.4 .OLS models: Ownership and Control Structures and Dividends

This table reports the estimates for OLS regressions of the dependent variable DIVIDEND PAYOUT RATIO (dividends paid over Net Earnings) on several independent variables. The regressions are run on samples firms with controlling shareholders. The sample period is 1996-1999. The regressions include the cash-flow rights (CF-RIGHTS) ;MODEL 1, control-ownership wedge of the largest shareholders (CFCR); MODEL 2 , control-ownership wedge of the largest shareholders (CFCR) for dual-class equity firms; MODEL 3, control-ownership wedge of the largest shareholders (CFCR) for pyramidal firms; MODEL 4, only the control-rights of the largest shareholder(STCR); MODEL 5 ,both control-rights of the second largest shareholder (NDCR) and largest shareholders (STCR) for dual-class equity ; MODEL 6, control-ownership wedge of the largest shareholder for controlling group formed by more than two largest block holders in control coalition (CFCR);MODEL 7 and control-ownership wedge of the largest shareholders for controlling group formed by only the first two largest block holders in control coalition (CFCR);MODEL 8. The data necessary to build the variables is extracted from Thomson DataStream and WoldScope. The ownership variables are constructed from Faccio and Lang (2002) ownership database. For a particular firm, the variables *SIZE, FCF, GRTH, IR and PROF are* computed using information as of the end of the fiscal year one year after the year in which ownership variable is extracted. *SIZE is* the natural logarithm of book value of total assets, FCF is the free cash flows scaled to total assets, is the ratio of total debt to total assets, LEV is the ratio of total debt to total assets, GRTH is the three years average of sales growth rates, IR is the capital expenditure over fixed assets and ROA is the EBIT scaled to total assets. For each independent variable, the table shows the coefficient estimates and the t-statistic accompanied with *, **, or **** to reflect the statistical significance at 10%, 5% and 1% significant level respectively, and t-statistics in bracket. Industry dummies are included in the models and reported as INDUMMY

DEPENDENT VARIABLE- DIVIDEND PAYOUT RATIO								
Variable	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
CF-RIGHTS	0.125*							
	(1.76)							
STCFCR					-.0186	-.0009		
					(-0.21)	(-0.01)		
NDCFCR						-.3162		
						(-1.24)		
CFCR		-11.182**	-14.371**	-19.277***			59.2979**	-27.335
		(-2.30)	(-2.20)	(-3.22)			(2.36)	(-0.87)
SIZE	2.370***	2.7949***	2.667***	2.776***	1.951	1.9109	1.3762	2.655**
	(3.90)	(4.22)	(3.05)	(3.63)	(1.35)	(1.35)	(1.23)	(2.07)
FCF	-0.022***	0.0176*	0.0125	0.003	-.011	-.0114	-0.0007	-0.002***
	(-5.60)	(1.69)	(1.05)	(0.29)	(-1.38)	(-1.36)	(-0.06)	(-3.34)
LEV	0.013***	-0.0085	0.1485	-0.015*	.0119***	.0119***	0.0108***	0.078
	(5.53)	(-0.93)	(1.37)	(-1.72)	(6.49)	(6.42)	(4.25)	(0.79)
GRTH	-0.012	-0.2334***	-0.213**	-0.414***	-.296***	-.2961***	-0.369***	-0.170
	(-0.2)	(-3.25)	(-2.48)	(-4.62)	(-3.11)	(-3.13)	(-4.05)	(-1.59)
IR	0.360***	0.2394	0.316*	0.1077	-.055	-.0544	-0.021	0.076
	(2.99)	(1.38)	(1.74)	(0.43)	(-0.73)	(-0.75)	(-1.41)	(0.53)
ROA	0.378***	0.2564***	0.305***	0.198***	.286***	.2869***	0.271***	0.2634***
	(7.16)	(4.86)	(3.59)	(5.25)	(5.99)	(6.00)	(5.03)	(2.92)
CONSTANT	8.677**	23.4596***	24.051***	30.541***	24.013***	28.5612***	-28.961	41.6945
	(2.37)	(5.03)	(3.67)	(5.49)	(2.74)	(3.00)	(-1.21)	(1.41)
R^2/Pseudo R^2	0.172	0.177	0.178	0.286	0.152	0.158	0.246	0.151
F-stat	30.20***	14.76***	8.44***	17.3***	35.84***	31.64***	25.78***	6.39***
INDUMMY	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	313	255	170	124	199	199	96	103

5.5 Chapter Summary and Concluding Remarks

Generally, this chapter examines the impact ownership and control on dividends. The results presented in this study report that, those companies with dual-class equity structures and pyramidal structures are reported to be involved with corporate value reduction. It is concluded that corporate controlling block holders can choose to invest excess cash flows in projects with negative NPV as long as they benefit privately from these investments. The impact of this is that, unprofitable projects may accumulate corporate debts over a period of time and this may ultimately result in bankruptcy which is costly to all shareholders, both majority and minority.

The study reports that the level of control-ownership wedge matters in the. In an attempt to get more insights, a t-test is performed to test whether companies with lower control-ownership wedge have more potential to expropriate than those companies with higher control-ownership wedge. It is concluded that while companies with a lower control-ownership wedge pay fewer dividends and retain more cash for their private deals, those companies with a higher control-ownership wedge will have an incentive to pay more dividends, as they expect a higher proportion of corporate profits, because they have relatively higher cash flow rights.

The t-test results are supported by both OLS and Tobit regressions which suggest a negative and statistically significant relationship at 5% significant level between control of the largest shareholder and the dividend payout ratio. The regression results support the prediction of this study about the incentive and ability of the largest shareholder to extract private benefits by utilizing corporate excess cash flows in projects of their own interests which do not benefit other smaller shareholders.

When dual-class equity structures and pyramid structures are considered as mechanisms used to separate ownership from control, the separate regressions for both mechanisms show that dual-class equity structures create more deviation between control rights and cash flow rights than pyramidal structures. This is confirmed when the regression results of the two mechanisms are compared. It is observable that the relationship between control-ownership wedge and dividend is negative for both dual-class equity and pyramidal firms but the strength of the relationship differs. The results show that the negative relationship between control-ownership wedge and dividend payout ratio in pyramidal companies is weaker (statistically significant at 5% significant level) than that in pyramidal companies (statistically significant at 1% significant level).

On the other hand, the study also confirms an efficient monitoring hypothesis for companies whose ownership and control are not separated. The results show that the ownership of the largest shareholder in companies with a one-share one-vote framework is positively related to the dividend payout ratio. The results support the contention that the more cash-flow rights the largest shareholder holds, the more incentives they have to pay dividends, as the distribution of cash flow is associated with their increase in wealth.

The study also tries to examine whether the presence of the second largest shareholder reduces the ability of the largest controlling shareholder to extract private benefits. Contrary to the expectation of this study the result concludes that the presence of the second largest shareholder does not have any impact in reducing the control of the largest shareholder. This is consistent with previous strands of the literature such as Maury and Pajuste, (2005) who contend that the mere presence of second largest shareholder does not matter. What matters is the type of the second largest shareholder and the size of the second largest shareholder relative to the largest.

Finally, the study attempts to assess the impact of control coalition formation on corporate dividend decision. The study splits the main sample into two groups, those companies in which the stakes of the first two largest block holders add up to more than 50% and those in which the stakes of three or more holders are required to exceed 50%. It is confirmed that companies with control coalitions having more than two members pay more dividends than those companies whose controlling group comprises of only two members.

This confirms that, in coalitions with more than two block holders of different types, payment of dividend may easily be suggested and deals to misuse corporate funds may not be successful resulting into disagreement. This disagreement favours minority shareholders because if the idea of retaining money for private benefits extraction is rejected, then the cash is distributed as dividends.

This interpretation can further be extended to the following arguments: coalitions formed by only two block holders may reach agreement easily because in most cases (more than 50% in our sample) the coalition of this nature is made up of both members of similar type such as family companies or widely held financial institutions. Since two members of the same type are believed to know each other better and may have similar philosophies, missions, objectives and goals they can easily conclude the deal. In fewer than 10% of all cases in our sample, members of controlling groups in companies with more than two coalition members are of the same type. This supports the contention that it is difficult to reach agreement in the decision making process when the controlling group has many members and the members are not of the same type.

Finally, the study finds statistically stronger relationships between dividend payout ratio and control variables such as growth opportunities, profitability and firm size in most of the models than the relationship between dividend payout ratio and ownership and control variables. This was expected due to the limitations and weaknesses of the weakest link

principle employed by Faccio and Lang (2002) in measuring the control rights and cash flow rights as described in the methodology chapter. As explained before there is no theoretical foundation for the use of this principle to measure ultimate owners' control rights. Hence its use may not properly reflect the exact relationship between dividend payout ratio and ownership and control variables. Furthermore, the use of threshold values above which owners' voting rights are regarded as giving control and below which they are not is inevitably arbitrary, and leads to counter-intuitive outcomes.

Another limitation of using the weakest-link principle in measuring control rights is that it is unclear how to incorporate multiple owners into the weakest-link principle when there are two or more ultimate owners in a control chain into the weakest-link principle. Therefore, the interpretations of these results require careful consideration of these limitations. However, regardless of these limitations, the basic relationships are observed to be reflected consistent with the predictions.

CHAPTER SIX

6.0 OWNERSHIP, CONTROL AND CAPITAL STRUCTURE

6.1 Introduction and Motivation

The objective of this chapter is to explore the impact of ownership and control structures on capital structure. In a modern corporation, ownership is separated from control because owners may lack the time, skills and experience required to manage the corporation. In this case professional managers are employed to control corporations on behalf of the owners. However, the challenge is that, managers can have their own personal interests which deviate from the objective of the firm (Berne and Means, 1932).

Management's unfavourable behavioural patterns, which affect firm value, may be limited by several approaches. One, among others, is monitoring by large external shareholders. The literature highlights the impact of institutional shareholders' voting power in corporate decision making, as seen in such areas as choice of value-maximizing capital structure. Shleifer and Vishny (1986) contend that, the external larger shareholders are vital agents in monitoring managerial selfish behaviours and hence in reducing direct agency costs. Monitoring by external block-holders limits the possibility of management adjusting the corporate capital structure in their own favour. This, according to Shleifer and Vishny, implies a positive association between corporate debt ratio and external block-holdings.

However, Shleifer and Vishny also propose that the position of controlling shareholders is similar to that of highly-entrenched managers because controlling shareholders, with their higher level of stake holdings, may divert company resources so as to extract personal

benefits which can affect a firm's value and expropriate minority shareholders. This creates agency conflict between majority shareholders and minority shareholders.

Debt may play a very crucial role in limiting the misappropriation of corporate excess cash flows as previously suggested Jensen and Meckling (1976) and further developed by Jensen, (1986). However, this role depends on the structure of corporate ownership and control. The conflict between minority and majority shareholders becomes serious if the controlling shareholders accumulate more control by applying control-enhancing mechanisms such as pyramidal structures and dual-class structures.

According to Faccio *et al. (2003)*, when the company fails to honour its debt obligations, the net worth of professional managers might not be affected although their reputations and careers may be at risk. For the controlling shareholder of a corporate group, who holds a top corporate managerial position and can borrow through a group affiliate from a group bank, this might not be a concern because, by, say, pyramiding, he can control corporations and banks at the bottom with a low stake and then use money borrowed from the bank to shift resources up to the apex of the pyramid where he has a significant ownership stake. This may result in expropriating shareholders and bank depositors at the bottom of the pyramid. Therefore, debt may be considered to play two roles here: first, to limit misuse of corporate funds by professional managers, as in the US, and yet to facilitate such misappropriations.

In the UK, using the data employed in this study, about 25% of ultimate controlling shareholders are financial institutions such as banks. This suggests that these block holders may have control over the provision of loans in their institutions and can, therefore, easily facilitate offering huge loans to companies in which they have financial interests. Thus, debt may not be used as monitoring device but rather as an expropriation device.

This expropriation tactic is more popular in corporations with pyramidal structures where controlling block holders of the corporate groups dominate the business scene. As Faccio *et al.* (2003) put it: "*Within a corporate pyramid, increased indebtedness by an affiliate need not constrain expropriation by the controlling shareholder because the debt can be rolled over by group banks, recycled into external loans guaranteed by other affiliates, or reshuffled ahead of auditors to other affiliates by intra-group loans or transfer pricing. Even a default by the affiliate need not damage the reputation of the manager/controlling shareholder if the affiliation is through obscure control webs passing through several layers of the pyramid. In any case, reputational damage can be shrugged off by a manager/controlling shareholder who employs himself within the pyramid, in contrast to the severe problems that default would cause a professional manager thrown onto the external manager market tainted by clear responsibility for the defaulting firm. Thus, the higher fixed obligations implied by the affiliates higher debt need not constrain the controlling shareholder more tightly".*

The study also has evidence, from the ownership data it employs, that dual-class equity structure is used by controlling shareholders more, even, than pyramidal structures as control-enhancing mechanisms. The statistics show that for those corporations which separate ownership from control, 83% of them do so via pyramiding (34%) and dual-class equity structures (49%). Therefore, it is important to look at the impact of these control structures on corporate leverage.

This study is aware of the few UK published studies on the impact of ownership and control structures on capital structure. One of these studies is that of Short *et al*. (2002) which explores the impact of ownership structure on capital structure. In their study, Short *et al.* (2002) take into account only institutional and managerial ownership. The present study

considers complex control structures such as multiple large shareholders, pyramiding and dual-class equity structures and examines their impact on capital structure. The study also presents new evidence of the impact of the composition of a controlling group on capital structure. To the best of my knowledge, few (if any) studies of this kind have been conducted in the UK.

UK ownership data for 643 listed non-financial companies in LSE for the period 1996-1999 is used in this study. Applying Univariate analysis, by testing the mean difference in voting rights between companies with larger voting rights of the largest shareholder and those with lower voting rights of the largest shareholder, the results of this study show that companies with larger voting rights of the largest shareholder have more debt ratio compared to those with lower voting rights. This finding reflects the fact that those companies with higher voting rights of the largest shareholder have more potential to expropriate the interests of minority shareholders by issuing more debt and may in turn use that debt for their own private deals.

Using a sub-sample of companies whose ownership and control are not separated, the regression results for the relationship between the largest block holder's ownership concentration and corporate leverage show supportive evidence of a statistically significant positive relationship. The observed positive coefficient is consistent with the argument that companies with highly concentrated ownership do not prefer equity financing over debt financing in order to maintain their control and avoid dilution.

Furthermore, the study examines the effect of separating corporate ownership from control and the results show that, as the deviation between control-rights and cash-flow rights of the largest shareholder decreases, the debt ratio decreases and when the deviation between control-rights and cash-flow rights increases there is an increase also in debt ratio. This

finding supports directly the expropriation hypothesis, offering some evidence for the debt-increasing effect of the hypothesis formulated in this research: the non-dilution entrenchment effect and signalling effects of debt finance contribute to a higher corporate debt level when control-rights and cash-flow rights of the largest controlling shareholder are effectively separated.

The study further shows that, for corporations whose ownership and control are separated, family controlled firms report larger debt ratios than non-family companies. It is suggested that the use of more debt in capital structure is an indication of the potential for expropriation, since debt is recognized as an expropriation device in companies whose control and ownership are separated. Data employed in this study shows that the deviation of ownership from control in family companies is significantly greater than in non-family companies suggesting that family companies use more debt rather than equity to avoid control dilution so as to make it easy for them to extract private benefits resulting from their position of control.

The study further examines the monitoring role of the second largest shareholder on the control of the largest shareholder. Contrary to expectations, it is reported that the presence of a second largest shareholder can increase the incidence of expropriation of minority shareholders. This is consistent with the collusion effect between the second largest shareholder and the largest. The results show that, when the voting rights of the second largest shareholder are introduced into the model with only voting rights of the largest shareholder, the positive relationship between the voting rights of the largest shareholder and debt ratio becomes more statistically significant.

Finally, to examine whether the identity of the largest and second largest shareholders matter in corporate financial decisions, two sample mean comparison tests are employed. The results show that, companies where both of the two largest shareholders are family firms use more

debt in their capital structures than companies whose largest shareholder is a family and the second largest is a financial institution. This finding is consistent with the control incentives of family companies. In an attempt to retain the control, family companies use more debt in their capital structures so as to dilute the control of other shareholders blocking out take-over possibilities.

The chapter continues as follows: section 6.2 formulates the hypotheses followed by section 6.3 which outlines the empirical methods used to analyse the data. While section 6.4 presents the empirical results of the study, section 6.5 checks the robustness of the results and finally, section 6.6 summarises and concludes the chapter.

6.2 Related Literature and Hypotheses Development

6.2.1 Direct Equity Ownership and Corporate Leverage

6.2.1.1 Ownership Concentration of the Largest Controlling Block Holder

In a growing business, external financing is an unavoidable practice. The source of this finance is commonly either equity finance or debt finance. According to Harris and Raviv (1988), when deciding on which source to employ, controlling shareholders are more drawn to debt finance because of the non-dilution motives. This is the motive whereby controlling shareholders prevent their control diminishing by blocking out other equity block holders' efforts to bring in capital and dilute their control.

According to Jensen and Meckling (1976), shareholders of a company with more concentrated ownership may prefer less debt as long as it facilitates monitoring. Rajan and Zingales (1995) also supports this effect of ownership concentration on capital structure.

However, companies may prefer debt over equity if issuing equity means diluting or losing their control. Therefore, shareholders of firms with highly concentrated ownership will not

prefer issuing equity instead of debt so as to maintain their control over corporate assets if they have confidence about the future growth potential of the company.

It therefore, follows from this discussion that the more concentrated the firm's ownership is, the more likely existing shareholders are to issue debt instead of equity when the company requires funds. This results into the first testable implication:

Hypothesis One

The ownership concentration of the largest shareholder is positively related to corporate leverage.

6.2.1.2 Control Motives and Owners' Identity

Literature on family ownership provides evidence that families have the same desire for control as any other group of corporate owners. It is obvious that families traditionally have long lasting commitment to their firm which goes beyond financial performance. According to Chami (1999) and Becker (1981), founding families do not consider their firm in terms of cash generated, but rather they go beyond this and consider passing the ownership to future generations of family members. This affects a family block holder's exercise of control over a firm's decisions, as emotion may play a role, as will the impact of any decision on future generations.

According to Anderson and Reeb (2003), since most family block holders concentrate their investments into a few industries, they are more likely to be associated with a relatively higher firm-specific/industry-specific risk. To avoid such a risk, strong controls should be put in place. According to Harris and Raviv (1988), increase in debt may be used as an attempt to block the takeover of the company hence protecting their control. The authors suggest that, as long as the families' votes exceed the incumbents', the increase in debt reduces the likelihood of takeover, although too great an increase in debt may open the

possibility of bankruptcy, which clearly has the dramatic impact of losing accumulated control.

Anderson and Reebs (2003) identify institutional block holders as a group of block holders with high control motives over firms' decisions. Along the same line, King and Santos (2008) contends that family firms and institutional firms both have higher debts in their capital structure. According to Anderson and Reebs, although institutional block holders have motives for control, they are outperformed by family block holders who are always considered as active managers of the firm as opposed to institutional block holders who, in the US and many other countries, are legally banned from sitting on the board of directors of the firm in which they have holdings.

More support of this view is provided by Tufano (1996) who adds that, institutional investors usually own shares in different companies; hence, they have to split their monitoring time between their various investment portfolios. Furthermore, Gillian and Starks (2000) and Karpoff (2001) both insist on the ineffectiveness of institutional investors in monitoring firms and state that institutional investors' activism contributes little in a firm's governance change. This leads one to confirm that the monitoring motives exerted by institutional block holders may be relatively low as compared to the ones exerted by family block holders, enough to influence the capital structure of the firm.

Furthermore, while institutional investors are believed to be driven by agency theory, family owners are governed by stewardship theory where they are the stewards of the firm. It is contended that in a stewardship perspective managers' interests go beyond economic self-interest. Stewardship literature further suggests that family owners have a deep emotional investment in firms they control as previously contended by Bubolz (2001). According to the

author the prosperity of family firms, their personal fulfilment and public reputation are attached to the business.

Therefore, family firms struggle to accumulate more control and avoid issuing equity to maintain control. When the requirement for funds arises, family firms would traditionally prefer issuing debt. Due to difference in control motives between family-block holders and institutional block holders, the following testable implication is suggested:

Hypothesis Two

Companies with control in the hands of family block holders are expected to have higher debt ratio compared to their counterparts controlled by institutional block holders.

6.2.2 Separation of Ownership and Control and Expropriation Effect

There exists substantial literature such as Berger *et al.* (1997), Firth, (1995) and Lang *et al.* (2004), which examines the disciplinary role of debt in firms with dispersed share ownership. The results from these studies are consistent with Jensen (1986) who considers debt as an obstacle to managers who intend to divert corporate recourses for their own benefit. Limited studies are available on the role of debt on companies with complex control structures where controlling shareholders own shares in companies directly or indirectly. However, debt is believed to lose its disciplinary ability in companies with ultimate equity ownership. The reason for this is that there is a complex control structure which may be used by controlling shareholders to expropriate minority shareholders. According to Bertrand *et al*. (2004), the discrepancy between control-rights and cash-flow rights in firms with ultimate ownership widens the possibility for minority shareholders' expropriation.

Controlling shareholders may use debt to enhance expropriation by forcing their subsidiaries to raise more external debt, reorganising this via intercompany transactions and finally facilitating deployment of corporate resources for their own preferred projects (Atanasov *et al.* 2009). However, the expected bankruptcy which is considered as the disciplinary mechanism for over-usage of debt is avoided because controlling shareholders in structures such as a pyramid have limited liabilities for the insolvency of their subsidiaries and the loss of reputation is minimal because it is difficult to hold them responsible due to the complexity of the control web.

Following this argument, it may be suggested that for companies with controlling shareholders having more control-rights than cash-flow rights, debt is used to facilitate the expropriation of minority shareholders rather than being used to enhance control. According to Johnson (2000), in affiliates located at the bottom of the pyramid structure, controlling shareholders have high voting rights but low cash-flow rights.

The deviation between the two rights creates incentives to transfer resources from the bottom to the top where controlling shareholders have larger cash-flow rights. Johnson (2000) refers to this transfer of resources as "tunnelling". According to Johnson, tunnelling includes, among others, "*a wealth transfer among affiliate firms through transfer pricing, using assets of one group member as collateral for another, inflated payments for intangibles such as patents, brand names and insurance."* According to Faccio *et al.* (2003), controlling shareholders may expropriate the interests of minority shareholders by instituting a higher level of debt in firms where they have lower cash-flow rights, and transfer that to affiliates where they can explore their own preferred projects without being detected by minority shareholders due to the complex control web in pyramids. This argument is consistent with the expropriation hypothesis which postulates the theory as follows:

Hypothesis Three

The deviation of control rights from cash flow rights (measured by control-ownership wedge) of the largest controlling block holder negatively relates to corporate debt ratio.

6.2.3 Multiple Large Shareholders, Leverage and Expropriation Effect

6.2.3.1 The role of the second largest shareholder

Literature provides at least two views on the role of the second largest shareholders. On one hand, according to Pagano and Roell (1998), to avoid the diversion of corporate resources by the largest controlling shareholder, the second largest shareholder or/and other shareholders with substantial holdings tend to limit the largest controlling shareholder's selfish behaviour because they have their own incentive to monitor. On the other hand, the second largest shareholders may collude with the largest shareholder to expropriate the interests of the minority shareholders (Zwiebel, 1995). According to Zwiebel, the distribution of private benefits among controlling shareholders depends on the respective size of their holdings. Therefore, the smaller the holding of the shareholder, the lower is their share of private benefits.

Maury and Pajuste (2005) constructed a model considering multiple block holders' relative size and identity. According to their model, higher voting power increases the ability to extract private benefits and lower cash flow-rights reduces the incentives effect. According to La Porta *et al.* (1998) and Pagano and Roel (1998), the second largest shareholder and other shareholders may have the incentives and the ability to monitor the behaviour of the largest shareholder if, and only if, they own a sufficient portion of the company's shares. The monitoring process is executed in two forms. The first form is challenging for control by forming a controlling group to secure the benefit of control as suggested by Bennedsen and Wolfenzon (2000).The other form is cross-monitoring each other as suggested by Pagano and Roel (1998).

Given the view that higher debt relates closely to the possibility of expropriation of minority shareholders, the relationship between voting rights of the second largest shareholder and debt will either be positive or negative depending on whether the second largest shareholder monitors or colludes with the largest shareholder to extract their own benefits. As implied from Bennedsen and Wolfenzon (2000), the voting rights of second largest shareholder directly relate to debt, if collusion occurs, while the same is negatively related to debt in a case where the second largest shareholder effectively carries out their monitoring role.

It therefore follows that, whether the second largest shareholder colludes with the largest shareholder to extract private benefits, or monitors the behaviour of the largest shareholder is a matter of empirical analysis. Following the view that the second largest shareholder monitors well the largest shareholder, the following view may be made:

Hypothesis Four

a) *The control-rights of the largest shareholder positively relate to the debt ratio.*
b) *The inclusion of the control-rights of the second largest shareholder in the relationship between control-rights of the largest shareholder and debt ratio reduces the statistical significance of the relationship in (a).*

6.2.3.2 The Identity of the Largest and Second Largest Shareholder

Multiple large shareholder structure can be viewed as a corporate governance device which reduces the tendency of controlling shareholders to expropriate the minority shareholders (through monitoring effect). It is possible that some family-controlled firms may have institutions in their ownership structures. Therefore, it is worth establishing the ability of these institutions in limiting families using their accumulated powers to expropriate the interests of the minority shareholders. According to Santos (2008), family block holders use

debt as a mechanism to accumulate more decision-making power in the firm. On the other hand, institutional block holders may intervene in the family block holders' plan to issue more debt when the firm require funds.

Bennedsen and Wolfenzon (2000) suggest that the formation of a ruling controlling group is relatively hard if the members of the groups are not of the same type. More specifically, the collusion effect becomes easier - meaning that the marginal cost of extracting private benefits seems to be lower for the controlling group comprising of both the second largest and the largest shareholder in family companies as opposed to coalition groups where the largest shareholder is a family company and the second largest an institution (especially a financial institution) (Maury and Pajuste, 2005). It can be realized that, because a family firm is composed of members of the family with similar goals and trust, it becomes easy for them to agree on any plan even if it is not benefiting the firm as a whole.

According to the Maury and Pajuste (2005), it is difficult for the largest shareholder, for instance in a family company, to collude with financial institutions in an attempt to extract private benefits because this action becomes more costly if the deal is recognized. This may be more risky for financial institutions as the opportunity cost of being caught diverting a firm's resources is higher for them, since they are being supervised by regulatory authorities. In relation to this argument one may predict the following testable implication:

Hypothesis Five

"The firm where both the first two controlling shareholders are family companies employs more debt in its capital structure compared to the firm where the largest block holder is a family while the second largest shareholder is a financial institution.

6.2.3.3 Control Contestability

Theoretically, according to monitoring effect, apart from the largest shareholder, the existence of other large shareholders with relatively large stakes in a business creates an incentive for them to monitor the largest shareholder for the purpose of limiting him/her from extracting personal benefits (La Porta *et al.* 1999 and Pagano and Roell, 1998). In so doing the interests of the minority shareholders are protected, resulting in the maximization of shareholders' wealth. The control ability of the second largest shareholder depends on the difference between the stakes of the second largest and the largest. According to Maury and Pajuste, (2005), the smaller the difference, the greater is the control ability of the second largest shareholder, and vice versa. The relative size of shares owned by the controlling shareholder and other block holders is said to influence the extent to which the largest shareholder expropriates the minority shareholders.

Bloch and Hege (2001) contend that, low contestability reduces the control competition among large shareholders leading to less commitment to refrain from private benefit extraction. According to Zwiebel (1995), extraction of private benefits by larger shareholders is proportional to their respective control stakes. This means that the higher the contestability, the more powerful is the largest shareholder, and the lower the contestability, the less powerful is the first largest shareholder, reflecting lower probability of the expropriation of minority shareholders' interests.

The literature on expropriation recognizes debt as one of the control-enhancing mechanisms which ultimately leads to expropriation. The largest shareholder whose voting rights exceed cash-flow rights would prefer to take more debt so as to explore more risky projects which may be detrimental to the owners' wealth. However, in most cases such projects are not beneficial to the minority shareholders. Because the largest shareholder's cash-flow rights are relatively lower, in an extreme case, where the firm becomes bankrupt as a result of default

risk, she/he has little to lose. This results in the formulation of the following testable implication:

Hypothesis Six

The size of the second largest shareholder's voting rights relative to the largest is positively related to the corporate debt ratio.

6.3 Empirical Analysis and Results

6.3.1 Empirical Methods

In this chapter cross-sectional OLS regression is carried out using the sample of 643 UK non-financial companies between 1996-1999. Because our argument is, in essence, cross-sectional, this methodology is the most suitable one. The use of panel regression is also common in capital structure studies, but one potential problem we face when applying panel regression is the relative time-invariance of ownership variables, which is a problem in our case, as the ownership variables of this study are taken at one point, year 1998. Consistent with Faccio and Lang (2002), La Porta *et al.* (1999) and Laeven and Levine, (2008) we observe that, ownership does not change significantly over time.

Some previous studies such as Rajan and Zingale (1995) and Bevan and Danbolt (2002) employed Tobin regressions in works similar to this, due to the presence of some observations on debt ratio with zero values. Hence, censored regression was necessary in this case. However, their results are consistent with the results generated from the OLS regression. In fact about 13% of debt ratio observations in our study have zero value and therefore, the study uses Tobit regression for testing the robustness and consistency of the reported results. Our model is a pooled OLS regression specified as follows:

$$DT_{i,t} = \alpha + \beta_1 * OWN_{i,t} + \beta_2 * ROA_{i,t} + \beta_3 * FSZ_{i,t} + \beta_4 * VOLAT_{i,t} + \beta_5 * SGR_{i,t} + \beta_6 * FCF_{i,t} + e_{it}$$

Where;

$DT_{i,t}$ =Leverage at time t

$OWN_{i,t}$= Cash-flow rights of the largest shareholder, Control-rights of the largest shareholder or control-ownership wedge (Cash-flow rights/Control-rights)

$FSZ_{i,t}$ =Firm Size

$VOLAT_{i,t}$ =Volatility (Variations of corporate returns)

$ROA_{i,t}$=Returns on Assets

$FCF_{i,t}$ =Free Cash Flows

However;

$$DT_{i,t} = \begin{cases} DT^{*}_{i,t} \text{ If } DT^{*}_{i,t} > 0 \\ 0 \quad \text{If } DT^{*}_{i,t} <= 0 \end{cases} \qquad \text{---------- (2)}$$

6.3.2 Empirical Results

6.3.2.1 Ownership Concentration, Control and Corporate Leverage

Using the sub-sample of companies whose ownership and control are separated, this section starts by testing the statistical mean differences between companies with above mean (higher voting rights) and below-mean (lower voting rights) values of voting rights. The test shows that companies with higher voting rights have greater mean debt ratios compared to companies with below-mean values of voting rights. The t-statistics show that the difference in mean debt ratio between the two groups of companies is statistically significant at 5% significant level as presented in Table 6.1.

The mean difference test preliminarily confirms that control attracts controlling shareholders to extract private benefits. Therefore companies with higher voting rights of the largest shareholder have more potential to expropriate the interests of minority shareholders by issuing more debt and using that debt for their private deals, while those companies with lower voting rights will avoid higher debt, as the potential for bankruptcy jeopardizes their substantial investments in the company in which they have higher cash-flow rights.

With a sub-sample of companies whose ownership and control are not separated, OLS regression between ownership concentration of the largest shareholder and debt ratio is run. Model 1 in Table 6.2 reports the regression results which show supportive evidence of a statistically significant positive relationship between the largest shareholder's ownership concentration and debt ratio. The coefficient of largest shareholder's ownership concentration is positive and statistically significant at 5% significant level.

In line with the size-effect argument, the firm size in this regression is positively related to debt ratio with a statistically significant relationship at 1% significant level as reported in

Table 6.2, model 1. This suggests that larger firms are highly levered because the size of the company is proportional to its profitability, hence borrowing capacity increases. This finding is consistent with the theoretical works of Scott and Martin, (1975) and Ferri and Jones (1979) and empirically supported by Agrawal and Nagarajan (1990).

Table 6.2, model 1 also reports a negative and statistically significant relationship between debt ratio and volatility at 5% significant level, suggesting that companies whose earnings have higher volatility are linked to potential bankruptcy, hence their borrowing capacity is impaired since variability of earnings of the company is a measure of safety of lenders' money; the more volatile the company's earnings, the less is a company's borrowing ability, and vice versa.

Furthermore, the table reports a negative coefficient on profitability which is consistent with Myers (1977)'s pecking order theory which suggests that profitable companies use available internal funds to explore available investment opportunities before they use debt as their preferred source of finance. This is empirically proved by Titman and Wessels (1988) and Friend and Lang (1988). The relationship between profitability and debt ratio is statistically significant at 5% significant level.

The results also report a positive and statistically significant at 5% significant level coefficient of growth opportunities. This is, as expected, consistent with previous results by Bradley *et al.* (1984) and Titman and Wessels (1988). This is in line with the results from the correlation table reported previously in table 5.12 reflecting that, as growth opportunities increase, according to pecking order theory, internal funds may not be sufficient to explore potential investments and therefore, the company needs to utilize more of its debt capacity.

Table 6.2, model 1 further shows a negative insignificant relationship between free cash flow and debt ratio. These results were not anticipated and the reason for this may be due to the fact that other independent variables in the model overlap and display multiple effects.

6.3.2.2 Owners' identity and Corporate Leverage

In this section the study tries to examine whether the shareholder's identity matters, in as far as corporate financial decision making is concerned. Different owners are said to have different objectives, goals and motivations (Thomsen and Pedersen, 2000). Major groups of firms with controlling shareholders are selected, namely widely-held financial institutions and family companies. To reveal how these two owner groups prefer different debt levels, t-test statistics is used to show whether companies owned by financial institutions and those owned by families have different debt ratios.

Table 6.1 shows that, companies controlled by families have more debt ratios compared to companies controlled by financial institutions. The debt ratio difference between the two groups of companies is statistically significant at 1% significant level. This is an indication that, when companies controlled by families need external funds, they do not prefer to issue equity and instead they issue debt. The first possible reason for this decision is suggested by some strands of the literature such as Ellul (2008) who contends that, family companies become reluctant to introduce more equity holders, because their control may be diluted and therefore, debt is used by family companies as a control-enhancing mechanism. Another reason may be protecting their firms from take-over threats as highlighted in Harris and Raviv (1988), and Stulz (1988).

6.3.2.3 Separation of Ownership and Control

This section presents the effect of separating corporate ownership from control. Regression results reported in model 2, Table 6.2 show that there is a negatively significant relationship between corporate control-ownership wedge and debt ratio. The relationship is statistically significant at 10% significant level.

A negative coefficient of control-ownership wedge shows that, as the difference between control-rights and cash-flow rights decreases, the value of control-ownership wedge increases. As a result the debt ratio decreases and when the difference increases the control-ownership wedge decreases resulting in an increase in debt ratio. The literature suggests that those shareholders whose control-rights are higher than their corresponding cash-flow rights may force their subsidiaries to raise more external debt, reorganising this via intercompany transactions and finally, facilitating deployment of corporate resources for their own self interest (Atanasov *et al.* (2009). This finding supports directly the expropriation hypothesis brought forward earlier. The results offer evidence for the debt-increasing effect of the hypothesis formulated in this research, *i.e.*, the non-dilution entrenchment effect and signalling effects of debt finance contribute to a higher corporate debt level when control-rights and cash-flow rights of the largest controlling shareholder are effectively separated.

Turning to control variables, it is reported that have statistically significant coefficients except free cash flows and volatility. Contrary to pecking order theory that profitable firms use internal funds to explore potential investment opportunities before borrowing, profitability is reported to be positively related to debt ratio and the relationship is statistically significant at 5% significant level.

This finding does not come as a surprise because it is already reported that, due to expropriation hypothesis, which is supported by the results, generated profits of the company

may have been directed to the extraction of private benefits by controlling shareholders and therefore further requirement of funding should be covered through borrowing. Table 6.2 further reports that firm size is positively related to debt ratio as predicted. The coefficient of size is statistically significant at 1% significant level. It is also reported that growth is negative and statistically significant at 10% significant level.

6.3.2.4. The Presence and Type of the Second Largest Shareholder

To assess the impact of second largest shareholder in monitoring the behaviour of the largest shareholders on corporate leverage, two separate regressions are set out and run. The first regression involves only the voting rights of the largest shareholder, to test whether the largest shareholder's control over corporate resources may facilitate potential expropriation. In the second regression both the voting power of the second largest shareholder and that of the largest shareholder are included.

The results presented in Table 6.2, model 3 show that, the coefficient of the largest shareholder's voting rights is positive and statistically significant at 10% significant level. As hypothesised before, a positive relationship between voting power and debt ratio is an indication of expropriation, because as the voting power of the largest shareholder increases, their incentive to extract private rent increases too, as it might be more beneficial compared to the investment compensation expected in the form of dividends.

Contrary to the expectation of this study, Table 6.2, model 4 reports that the presence of the second largest shareholder enhances the expropriation of the minority shareholders. This is consistent with the collusion effect between the second largest shareholder and the largest. The results show that when the voting rights of the second largest shareholder are introduced into the model with only voting rights of the largest shareholder, the positive relationship

between the voting rights of the largest shareholder and debt ratio becomes more statistically significant. In fact, the relationship becomes statistically significant at 5% significant level compared to the situation before introducing the second largest shareholder, where it was marginally significant at 10% significant level.

To examine whether the identity of the largest and the second largest shareholder matters in corporate leverage, two samples mean comparison t-test is employed. A sample of firms with multiple large shareholders is subdivided into two groups, the first group is the companies where both of the first two largest shareholders are family firms and the other group being those companies whose largest shareholder is a family and the second largest is a financial institution. The results of the means comparison test is presented in Table 6.1

The results show that, companies where both of the first two largest shareholders are family firms use more debt in their capital structures compared to companies whose largest shareholder is a family and the second largest is a financial institution. The difference in debt ratios between the two groups is reported to be statistically significant at 10% significant level.

This finding is consistent with the control incentives of family companies. In an attempt to retain control, family companies use more debt in their capital structures instead of issuing shares so as prevent dilution of their accumulated control, in circumstances where there is a need for external funds. This action eliminates take-over possibilities. With the assurance of control, family firms make some corporate decisions which are beneficial to family members and not the company as a whole. The motivation behind these decisions is to pass ownership and control of the company to coming generations.

6.3.2.5 Control Contestability

As described in the hypothesis development section, if the voting rights of the second largest shareholder increase, the opportunity for the second largest shareholder to collude with the largest shareholder also increases. Using the relative size of the voting rights values of the first two largest shareholders (the difference between the voting rights of the largest shareholder and second largest shareholder), this study examines the impact of the second largest shareholder in monitoring the largest shareholder's selfish behaviour in corporate debt level choice.

The sample of companies with multiple large shareholders is split into those companies with smaller relative size or lower control contestability (below-mean value of difference between the voting rights of the largest shareholder and second largest) and those with larger difference (higher control contestability/larger relative size). The analysis starts by testing the statistical mean difference of debt ratio between the two groups of companies. Table 6.1 shows that companies with higher contestability use more debt in their capital structures than those companies with lower contestability with the mean difference statistically significant at 5% significant level.

To shed more light on the relationship between control contestability and debt ratio, a linear regression is run with control contestability as an independent variable followed by various common factors which affect the dependent variable, debt ratio. Table 6.2, model 5 reports a positive and statistically significant relationship between control contestability and debt ratio. The relationship is reported to be statistically significant at 1% significant level. This supports the contention that the relative size of the voting rights between the largest and the second largest has a positive impact on debt ratio. As the gap between the voting rights of two groups widens the largest shareholders become more powerful and capable of exercising their power without any active monitoring from the second largest shareholder.

This is supported by the mean comparison t-test results reported in Table 6.1 that companies with lower control contestability have lower debt ratios than companies with higher control contestability. Generally, the second largest shareholder gains more power to monitor the behaviour of the largest shareholder when the deviation between the voting-rights of the two decreases. In essence, smaller values of control contestability signify more equal distribution of the voting power between the two largest shareholders. This finding is in line with the monitoring hypothesis of the second largest shareholder suggesting that the involvement of the second largest shareholder in monitoring the actions of the largest shareholder reduces the second-order agency costs, the agency conflict between minority shareholders and majority shareholders.

Model 5 in Table 6.2 further reports that some of the control variables show statistically insignificant coefficients such as free cash flows and growth opportunities. The coefficient for firm size is positive and statistically significant at 1% level showing that larger firms use more debt because they are reputable; hence their borrowing capacity is higher. Likewise, the relationship between profitability and debt is reported to be negative and statistically significant at 1% significant level. This is consistent with the pecking order theory of Myers (1977) that companies with good profitability use the available internal fund before taking a borrowing option. Hence, profitable companies use less debt, results which are in line with Titman and Wessels (1988) and Friend and Lang (1988).

Finally, the table shows a negative and statistically significant relationship between corporate earnings volatility and debt ratio. The relationship is statistically significant at 10% significant level. This finding shows that money lenders such as banks are very reluctant to offer loans to risky companies due to worries about default risk. Therefore, a corporate risk profile is a very important parameter for lenders to consider before issuing a loan to any

company. As a firm's earnings volatility increases, the debt ratio decreases as their borrowing capacity falls and vice versa.

Table 6.1 Univariate Tests on the Debt Ratio

In this table, the mean DEBT RATIOS are compared using standard t-tests on means. Information from Worldscope and firms' annual reports for the period 1996-1999 is used to build the values of debt ratios. For a particular firm DEBT RATIO is the ratio between the total debt and total assets. The mean values of the debt ratios for observations related to firms with controlling shareholders holding higher voting rights are compared to the mean values of the same variable for observations of firms with controlling shareholders possessing lower voting rights (HVR VS. LVR), Debt mean values of Family companies are compared with mean value of debt for financial institutions (FAMILY VS FIN. INST), firms with higher control contestability and those with lower control contestability (HCC VS LCC) and companies whose control coalition has both the largest shareholder and second largest, families and those with the largest a family and the second largest a financial institution.(FAMILY-FAMILY VS FAMILY-FIN.INST)*, ** and *** stand for statistically significant at 10%, 5% and 1% respectively.

VARIABLES	*HVR VS. LVR*	*FAMILY VS. FIN.INST*	*HCC VS. LCC*	*FAMILY-FAMILY VS. FAMILY-FIN. INST*
DEBT RATIO	2.24**	3.54***	2.16**	1.64*

Table 6.2.OLS models: Ownership and Control Structures and Debt ratio

This table reports the estimates for OLS regression of the dependent variable DEBT RATIO (Total debt over total assets) on several independent variables. The regressions are run on sample firms with controlling shareholders. The sample period is 1996-1999. The regressions include the cash-flow rights (CF-RIGHTS) ;MODEL 1, only the control-rights of the largest shareholder(STCR); MODEL 2 , BOTH control-rights of the second largest shareholder (NDCR) and the largest shareholders (STCR) ; MODEL 3, control-ownership wedge of the largest shareholders (CFCR); MODEL 4, size of control-rights of the largest shareholder relative to the second largest (CONTEST); MODEL 5. The data necessary to build the variables is extracted from Thomson DataStream and WoldScope. The ownership variables are constructed from Faccio and Lang (2002) ownership database. For a particular firm, the variables *SIZE, FCF, GRTH, VOLAT and PROF are* computed using information as of the end of the fiscal year one year after the year in which ownership variable is extracted. *SIZE is* the natural logarithm of book value of total assets, FCF is the free cash flows scaled to total assets, GRTH is the three years average of sales growth rates, VOLAT is standard deviation of share price measuring firm risk and PROF is the EBIT scaled to total assets. For each independent variable, the table shows the coefficient estimates and the t-statistic accompanied with *, **, or **** to represent the statistical significance at 10%, 5% and 1% significant level respectively, and t-statistics in bracket. The table also reports the number of observations and the value of the log-likelihood function for every regression. Industry dummies are included in the models and reported as INDUMMY.

	DEPENDENT VARIABLE – DEBT RATIO				
Indep: Variable	MODEL 1	MODEL 2	MODEL 3	MODEL 4	MODEL 5
CF- RIGHTS	0.009**(2.11)				
STCR			0.009*(1.98)	0.008**(2.04)	
NDCR				-0.101(-0.61)	
CFCR		-0.629*(-1.76)			
CONTEST					0.026***(3.31)
SIZE	0.892***(3.23)	0.001***(4.33)	0.871*** (7.19)	0.870***(7.04)	0.002***(3.84)
FCF	-0.004(-1.20)	0.004(0.43)	-0.001(-1.15)	-0.001(-1.15)	-0.001(-0.80)
GRTH	-0.006**(-2.30)	-0.005*(-1.66)	0.004 (0.67)	0.004 (0.66)	0.001(0.11)
VOLAT	-0.016**(2.48)	-0.002(-0.16)	0.137*(1.88)	0.014*(1.83)	-0.021*(-1.68)
PROF	-0.036**(2.09)	0.014**(2.38)	0.010** (2.13)	0.010**(2.13)	-0.008***(-3.74)
CONSTANT	-1.975***(-9.52)	3.203***(9.99)	-1.983*** (-8.43)	-1.836***(-5.31)	1.510***(5.51)
R^2 /Pseudo R^2	0.269	0.158	0.282	0.271	0.256
F-stat	4.52***	7.78***	7.90***	6.77***	7.98***
INDUMMY	Yes	Yes	Yes	Yes	Yes
Observations	313	534	198	198	198

6.4 Sensitivity Analysis

As in previous studies such as Rajan and Zingale, (1995) and Bevan and Danbolt, (2002) Tobin regressions are employed in this study to check for the consistency of our results. Tobit regression is considered necessary in this study due to the presence of some observations on debt ratio with zero values representing 13% of the whole sample observations. However, their results are consistent with the results generated from the OLS method.

In Table 6.2 and Table 6.3 the relationship between the voting rights of the largest controlling shareholder and debt ratio is tested and the relationship for both methods is reported to be positive and statistically significant at 1% significant level. When the role of the second largest shareholder in monitoring the largest shareholder is examined, the marginally statistically insignificant results, using Tobit regression are reported, though OLS reports relatively stronger statistically significant results. The relationship between debt ratio and control contestability for both Tobit and OLS regressions is reported in Table 6.3 and Table 6.2 respectively. It is shown that both methods report positive and statistically significant coefficients of control contestability measure although the relationship is more statistically significant using OLS (1% significant level) compared to Tobit regression (5% significant level).

Finally, Table 6.3 also reports the results of the relationship between the control-ownership wedge of the largest shareholder and debt ratio using both techniques and it is confirmed that in both methods the relationship is negative and statistically significant at 5% significant level.

Generally, it is confirmed that, the results for OLS are reported to be consistent throughout with those of Tobit regressions

Table 6.3.Tobit Models: Ownership and Control Structures and Debt ratio

This table reports the estimates for Tobit regressions of the dependent variable DEBT RATIO (Total debt over total assets) on several independent variables. The regressions are run on sample firms with controlling shareholders. The sample period is 1996-1999. The regressions include the cash-flow rights (CF-RIGHTS) ;MODEL 1, only the control-rights of the largest shareholder(STCR); MODEL 2 , BOTH control-rights of the second largest shareholder (NDCR) and the largest shareholders (STCR) ; MODEL 3, control-ownership wedge of the largest shareholders (CFCR); MODEL 4, size of control-rights of the largest shareholder relative to the second largest (CONTEST); MODEL 5. The data necessary to build the variables is extracted from Thomson DataStream and WoldScope. The ownership variables are constructed from Faccio and Lang (2002) ownership database. For a particular firm, the variables *SIZE, FCF, GRTH, VOLAT and PROF are* computed using information as of the end of the fiscal year one year after the year in which ownership variable is extracted. *SIZE is* the natural logarithm of book value of total assets, FCF is the free cash flows scaled to total assets, GRTH is the three years average of sales growth rates, VOLAT is standard deviation of share price measuring firm risk and PROF is the EBIT scaled to total assets. For each independent variable, the table shows the coefficient estimates and the t-statistic accompanied with *, **, or **** to represent the statistical significance at 10%, 5% and 1% significant level respectively, and t-statistics in bracket. The table also reports the number of observations and the value of the log-likelihood function for every regression. Industry dummies are included in the models and reported as INDUMMY.

DEPENDENT VARIABLE- DEBT RATIO					
Indep: Variable	MODEL1	MODEL 2	MODEL3	MODEL 4	MODEL 5
CF-RIGHTS	0.011***(2.85)				
STCR		.0130(1.38)	.0146 (1.43)		
NDCR			-.0272 (-1.29)		
CFCR					-0.762*(-1.76)
CONTEST				0.035**(2.08)	
SIZE	1.113***(3.43)	1.05***(8.62)	1.049***(8.80)	0.002***(3.24)	0.002***(4.0)
FCF	-0.001***(-3.26)	-.001**(-2.45)	-.001**(-2.39)	-0.001(-0.89)	0.004(0.46)
GRTH	-0.010***(-3.59)	.002(0.34)	.002(0.31)	-0.003(-0.28)	-0.008*(-1.67)
VOLAT	-0.020**(-2.15)	.007(0.77)	.008(0.90)	-0.035(-1.43)	-0.004(-0.02)
PROF	-0.041**(-2.13)	.010*(1.66)	.010(1.57)	0.013(1.24)	-0.018**(2.2)
CONSTANT	-3.373***(-2.79)	-3.240***(-2.26)	-2.867**(-2.26)	0.782(0.56)	3.143***(7.03)
R^2/*Pseudo* R^2	0.076	0.064	0.066	0.06	0.158
F-stat	8.42***	6.77***	3.71***	3.11**	4.14***
INDUMMY	Yes	Yes	Yes	Yes	Yes
Log Likelihood	-462.3243	-296.9943	-296.1529	-380.2287	-1128.2375
Observations	313	198	198	198	198

6.5 Chapter Summary and Concluding Remarks

Using t-statistical tests and linear regressions, the study produces several findings as follows:

After testing the relationship between the largest block holder's ownership concentration and corporate leverage, the results show supportive evidence of a statistically significant positive relationship between the largest shareholder's ownership concentration and debt ratio. These findings support the expropriation hypothesis. The study also reports that companies with higher voting rights of the largest shareholder have more potential to expropriate the interests of minority shareholders by issuing more debt and using it for their private ends while those companies with lower voting rights avoid higher debts, as potential bankruptcy resulting from applying higher debt impairs their substantial investments. On the other hand, block holders with higher voting rights fear less the prospect of bankruptcy because their loss is not severe when the firm fails as their cash-flow rights are not so significant.

The study also examines the effect of separating corporate ownership from control and the results show that, as the deviation between control-rights and cash-flow rights of the largest shareholder decreases, the debt ratio decreases and when the deviation between control-rights and cash-flow rights increases there is an increase in debt ratio. This finding supports directly the expropriation hypothesis offering evidence for the debt-increasing effect of the hypothesis formulated in this research: the non-dilution entrenchment effect and signalling effects of debt finance contribute to a higher corporate debt level when the control-rights and cash-flow rights of the largest controlling shareholder are highly separated.

To assess the impact of second largest shareholder monitoring on the behaviour of the largest shareholders in corporate financial decisions, two separate regressions are run. The first regression involves only the voting rights of the largest shareholder, the aim being to test whether the largest shareholder's control over corporate resources may facilitate potential

expropriation. In the second regression both the voting power of the second largest shareholder and that of the largest shareholder are included.

The results conclude that, contrary to the expectation of this study, the presence of the second largest shareholder increases the expropriation of the minority shareholders. This is consistent with the collusion effect between the second largest shareholder and the largest. The results show that when the voting rights of the second largest shareholder are introduced into the model, with the voting rights of the largest shareholder, the positive relationship between the voting rights of the largest shareholder and debt ratio becomes more statistically significant.

Regarding the impact of the largest shareholder's identity on corporate financial decisions, the study focuses on the two major groups of firms with controlling shareholders namely, widely-held financial institutions and family companies. The study reports that, companies controlled by families have higher debt ratios compared to companies controlled by financial institutions. This is an indication that when companies controlled by families need external finance, they do not choose to issue equity and instead issue debt. The first possible reason for this decision is suggested by some strands of the literature, such as Ellul (2008) pointing out the fear of introducing more equity holders. Families fear their control may be diluted and therefore the debt is used by family companies as a control-enhancing mechanism. Another reason may be linked to a desire to protect their firms from take-over threats as highlighted in Harris and Raviv, (1988), and Stulz, (1988).

The study further confirms that the relative size of the voting rights of the largest and second largest shareholder has a positive impact on debt ratio. As the difference between the voting rights of the two groups widens the largest shareholders become more powerful and able to exercise their power without any active monitoring from the second largest shareholders. It is found that when the gap between the voting-rights of the largest and second largest

shareholder decreases, the second largest shareholder becomes relatively more effective at monitoring the selfish behaviour of the largest shareholder in an attempt to reduce potential expropriation of minority shareholders.

In essence, a smaller value of control contestability signifies more equal distribution of the voting power between the two largest shareholders. This finding is in line with the monitoring hypothesis of the second largest shareholder, suggesting that the involvement of the second largest shareholder in monitoring the activities of the largest shareholder reduces the second-order agency costs, the agency conflict between minority shareholders and majority shareholders.

Finally, concerning the role of the second largest shareholder in limiting the expropriation activities of the largest shareholder, the study concludes that, the presence of the second largest shareholder may not matter and in some cases it can also make the expropriation severe. For instance, if the second largest shareholder is of the same type as the largest shareholder, or if the size of the second largest shareholder is significantly smaller than that of the largest shareholder, the possibility of expropriation increases. As confirmed from this study what actually matters is the nature and size of the second largest shareholder.

As previously discussed in chapter five of this study, control explanatory variables seem to have relatively statistically stronger relationships with debt ratio than ownership and control variables. This has been linked with the weaknesses and limitations of principle measure of the control rights and cash flow rights employed by Faccio and Lang (2002). Therefore, one must be very careful when interpreting these results. It seems like debt ratio is best explained by other explanatory variables than by ownership and control. Using more superior method than weakest link principle to measure control rights and cash flow rights may provide more accurate values of such proxies and lead to a more relatively reliable relationships.

CHAPTER SEVEN

7.0 OWNERSHIP, CONTROL STRUCTURES AND PERFORMANCE

7.1 Introduction

The objective of this chapter is to examine the impact of ownership and control structures on corporate performance. The agency conflict between managers and shareholders of companies with dispersed ownership structure (interest deviation between shareholders and managers) has been reported to affect corporate performance negatively as contended by Jensen and Meckling, (1976). According to the authors, various mechanisms such as market for corporate control, formation of board of directors and managerial compensations are suggested to reduce this problem.

The mechanism which recently has attracted the attention of researchers is direct monitoring by outside large shareholders. Most studies which address the role of large shareholders as a monitoring device consider influence of ownership concentration on firm value. (See for instance McConnell and Servaes 1990; Chung *et al.* 2002; Dalton *et al.* 2003; Joher *et al.* 2006; and more recently S´anchez-Ballesta and Garc´ıa-Meca, 2007).

The discussion of ownership structure remains incomplete if owners' identity is not taken into account because different firm's owners have different motives and unique interests. More specifically, it should be borne in mind that the diverse group of share owners have different levels of monitoring competence, different levels of wealth, different preferences about the way they like to receive the return on their investments, different cultures and so many cross-border differences, Thomsen and Pedersen (2000). According to the authors, the identity of firm's owners may determine their goals and this might have a great impact on the

firm's behaviour which ultimately affects the firm's financial decisions and firm value in particular. For instance, the interest of financial institutional investors may be to realize short term return on their investments and they would just sell their shares when the firm suffers a down turn while corporations or non-financial institutions may be more focused on the long term- relationship, hence, make effort to participate in a restructuring process, Douma *et al.* (2006). The good examples of include share ownership by corporations, financial institutions and family companies.

To the best of my knowledge, in published works, very few studies in UK (if any) address the influence of owners' identity on firm performance; hence the true nature of ownership might have been ignored. Literature shows that, the diverse group of share owners have different levels of monitoring competence, different level of wealth, different preferences about the way they like to receive the return on their investment and different cultures from different cross borders (Thomsen and Pedersen, 2000). According to the authors, the identity of firm's owners may determine their goals and this might have a great impact on the firm's behaviour which as a result affects the firm value. This study tries to contribute in literature by addressing how different owners' identity affects firm's value differently using sample of UK listed companies. More specifically, the study throws light on the impact of management professionalism on the performance of manager-controlled firms and family-managed firms.

From previous studies it is appreciated that, financial institutions are relatively better in monitoring managers than other investors due to their wide knowledge and competence in financial management, hence they should be able to monitor with higher quality at lower costs. But because they put more emphasis on firm's liquidity they don't bear long-term relationship with the firm they deal with, instead they take exit strategy as the firm suffers a liquidity problem rather than putting any effort to rescue the situation.

On the other hand, family owners focus on long term survival of the firm and they may struggle to keep the company going even in hard times. Unlike financial institutions, their motive is not liquidity but rather long-term performance of the firm; hence, they rarely take the exit strategy.

To add on these arguments, Bubolz (2001) argues that institutional investors are driven by agency theory as they act as agents of the firm while family owners are governed by the stewardship where manager's interests go beyond economic self- interest. Many of them contribute to firm's mission, firm's longevity and firm's stakeholders. According to Bubolz, family owners have a deep emotional investment in firms they control .Furthermore, it is suggested that, the prosperity of family firms, their personal fulfilments and public reputation are attached to the business.

However, because families have their own personal fulfilments and the business concept is transferred from one generation to the other, family companies may protect their control and prevent outside investors to dilute their control so that they have sufficient control to put in place their own managers who are family members after retirement or death of the founders to keep in place their business concept which is to be transferred to the coming generation.

Previous studies suggest a family companies' superior performance by indicating that families have valuable knowledge about the businesses (Anderson and Reebs, 2003). However, this study suggests that, the family business founder may have a sufficient knowledge about the business but because the family may not be willing to employ an outside professional manager, and prefer more the inside family manager, the manager within the family who takes over from the founder may not be as knowledgeable as the founder. Due

to the lack of managerial skills, inside manager may make managerial decisions which can jeopardize the corporate value.

This is supported by Morck *et al.* (2000) who find that heir-controlled companies perform poorly due the lack of sufficient management skills by heirs. Along the same line of arguments, Pérez-González (2006) reports that inherited control is detrimental to firm performance in particular when the 2eirs have not gained good managerial trainings. On the other hand, Cronqvist and Nilsson (2003) also suggest that families can easily entrench and take unprofitable investments.

In the sample firms used in this study, family firms are characterized to have more concentrated ownership than any other type of block holders. In fact the average family control-rights amount to about 42%. This may be used as a control-enhancing mechanism for family companies. Furthermore, it is found from the descriptive analysis that, of all the family controlled companies about 78% is controlled by family managers.

It is hard to believe that all these companies have superior managers derived within their families than could be employed from outside. This tries to suggest that internal managers are appointed so that they work under family spirit and prepare the company to be handled to the following generation even if they do not have sufficient managerial skills. It can be argued that, external managers are professionally trained and may use their managerial skills to boost up the firm performance. Hence, this study suggests that, those companies (which are generally widely held) which are controlled by professional managers are in a position to perform better than family-managed firms.

Current literature on agency costs recognizes agency conflict between majority shareholders and minority shareholders as the key problem because ownership is becoming more concentrated in markets which had a dispersed ownership structures in the past such as UK (Laeven and Levine, 2008 and Marchica and Mura, 2005). The agency conflict between majority and minority shareholders forms another motive of this chapter. The chapter examines whether multiple large shareholders can mitigate this conflict. The majority-minority shareholders' conflict is common in closely-held corporations with fewer block holders who get involved in corporate management.

Literature suggests that, shareholders in closely- held corporations have sufficient knowledge about the way a corporation is run (Laeven and Levine, 2008). Particularly, if the firm has a controlling shareholder, the shareholder actively involves in firm's operation by choosing the management in which he becomes among the top executives. This casts a doubt as to whether the controlling shareholder may act in a best way in order to prevent the interest of minority shareholders (Dyck and Zingales, 2004).There are different ways in which the minority shareholders can be expropriated by controlling shareholders. These include, according to Gomes and Novaes (2005), more compensation to majority shareholders and misusing the assets of the company for their own benefits.

Most previous studies view multiple large shareholders as competing for extracting private benefits at an expense of minority shareholders .Literature suggest that, the conflict of interest between majority shareholders and minority shareholders can best be solved by the presence multiple large shareholders because unlike a single large controlling shareholder, multiple large shareholders can hardly reach agreement to make a decision which is against firm's interest and in so doing they protect minority shareholders' interests and increase firm value, Gomes and Novaes (2005), Laeven and Levine (2008) and Maury and Pajuste (2005).

Furthermore, Attig *et al.* (2009) exploring the relationship between multiple large shareholders and cash holdings find that, the existence of multiple large shareholders in the company and distribution of voting rights altogether increase the cash holdings. Bennedsen and Wolfenzon (2000)' s model contends that, a single shareholder does not have enough power to control the firm and, therefore, these individuals need to combine their voting powers and before any decision is made all shareholders must agree on the matter in hand. This makes it difficult for expropriation to take place and hence improve the overall firm performance.

Literature provides evidence that different types of controlling owners have different interests and preferences. Maury and Pajuste (2005) contend that, larger shareholders form coalition so as to get controlling power to extract private benefits and that a controlling coalition whose members include financial institutions extract less private benefit than the coalition with a family firm because financial institutions are subject to control from regulatory authorities and they may be reluctant to involve into extracting private benefits. Along the same line the study examines the impact of size of the controlling group on firm performance. The study tests the disagreement effect that the more the members of the coalition group the better is the quality of financial decision passed but the fewer the members, the easier is the expropriation of minority shareholders as advocated by Hoskisson *et al.* (2002).

Furthermore, the chapter addresses the private benefits extraction hypothesis where some control structures such as pyramiding and dual-class equity structures are used to separate voting rights from cash-flow rights. Most previous ownership studies in the UK focus on one-share one-vote framework where cash-flow rights and voting rights are not separated. According to Marchica and Mura (2005) more than 10% of firms in UK are controlled through a complex structure and the degree of departure of control-rights from cash-flow

rights is reported being around 11% at 10% threshold. Therefore, this chapter explores the impact of separating the two rights on corporate value. Unlike previous studies, this study contributes in the literature by addressing the way of mitigating second-order agency costs, the conflict between majority shareholders and minority shareholders which is a common conflict when corporations have multiple large shareholders and separated cash-flow rights and voting rights.

Using the sample of 643 UK non financial listed companies, and applying a pooled OLS regressions, the results of this study shows that both ownership and control concentrations by the largest controlling block holder are negatively related to firm performance. This supports expropriation hypothesis suggesting a corporate value discount as previously reported by Claessens and Djankov (1999). The results of this study suggest that, at higher ownership concentration levels the firm value tends to decrease significantly.

The study further reports a negative and statistically significant relationship between control-ownership wedge and performance. This partly confirms the allegation that separation of ownership from control is associated with expropriation leading to the negative on corporate performance.

Furthermore, the OLS regressions report a positive relationship between the ownership of the largest shareholder and performance in manager-controlled firms, and a negative relationship in family-managed firms. These findings are consistent with the facts that external managers are considered to be professionally trained. Such professionals use their managerial skills to boost a firm's performance, as opposed to managers chosen from within the family, who might lack sufficient managerial skills as insisted on by Morck *et al.* (2000) who find that heir-controlled companies perform poorly due to the lack of sufficient management skills by heirs.

Using a t-test of mean performance difference between companies with multiple large shareholders and stand-alone companies, the results confirm that companies with multiple large shareholders show better performance than stand-alone companies. Among the companies with multiple large shareholders, those having lower control-cash flow rights deviation perform better than those with large deviation. These findings are consistent with those reported by Laeven and Levine (2008) who confirm similar results.

It is further reported that the size and composition of the corporate controlling group impact on firm performance. Regarding the size of the controlling group, the results show that companies with controlling group having more than two larger block holders have better performance than those companies whose control is shared between two largest block holders and those with a single controlling shareholder. These results confirm the hypothesis that size of the controlling group significantly affects corporate decision-making which ultimately affects a firm's performance.

Finally, the study tests performance mean difference between companies where both the largest and the second largest block holders are families, and companies with the largest block holder a family and the second largest a widely-held financial institution. The results show that, companies with two families in their controlling group have lower performance compared to those companies where the largest share-holder is a family and the second largest, a widely-held financial institution. The results are consistent with collusion effect view proposed by Maury and Pajuste (2005).

This chapter proceeds as follows; section 7.2 is about related literature and hypotheses developments followed by section 7.3 which presents the empirical analysis and results. Finally section 7.4 concludes the chapter.

7.2 Related literature and Hypothesis Development.

7.2.1 Ownership Concentration

The impact of ownership and control concentration in firm value has been a hot topic in ownership literature since the principal-agent theory was suggested by Jensen and Meckling (1976). According to the theory, the principal-agent relationship leads to the formation of large block holders which try to monitor the unfavourable activities of corporate managers which impacts on owners' wealth. The theoretical explanation of ownership concentration can be linked to agency-based theory's incentive alignment and the entrenchment hypotheses. Agency theory contends that ownership concentration prevents a deviation between managers' and corporate owners' interests (Leech and Leahy 1991). The literature suggests that ownership concentration is a measure of the shareholders' power to influence managerial decisions, to neutralize corporate diversification and increase shareholder value (Thomsen and Pedersen 2000) due to the alignment of interest and the private or shared benefits from control.

Apart from benefits the whole firm is deriving from the monitoring by controlling shareholders, minority shareholders suffer some consequences as a result of the misuse of power held by these institutions. According to Denis (2001), larger institutional shareholders accumulate benefits which are not enjoyed by minority shareholders and generally they take advantage of their decision-making power at the expense of minority shareholders. This view is also supported by Shleifer and Vishny (1997) who insist that minority shareholders are expropriated by institutional shareholders because the benefits extracted by institutional shareholders are not equally shared by minority shareholders whereas costs are equally borne by the two sides. Holderness (2003) in adding to this discussion highlights the view that institutions, having more share ownership in the firm, become too powerful to the extent that

they make decisions which are in their own interests, interests which sometimes also align with the interests of minority shareholders, and in this case, minority shareholders also benefit from institutions' decisions.

In supporting the self-servicing effect of institutional ownership, Pound (1988) identifies the source of conflict between minority shareholders and larger shareholders. According to him, the closeness of larger shareholders to a company's management is one of the sources of this conflict because if there is a business link between the company and large shareholders, their decisions sometimes become influenced by the desire to defend their personal interests attached to the business they are doing with the firm. In most cases they may side with managers to maximize their utility through their business deals and this is detrimental to the interests of the minority shareholders. It therefore follows that; firm value is negatively affected by ownership concentration (as in Burkart *et al*. 2000). These authors claim that concentration of ownership in the hands of large block holders provides them with the capacity to influence corporate decisions which might have negative effects because, according to the second-order agency theory, large block holders might pursue their own goals and extract private benefits at the expense of minority shareholders.

Other studies report a non-uniform relationship between ownership concentration and firm value – I am referring to studies such as Fama and Jensen (1983), Morck *et al.* (1988), and Shleifer and Vishny (1997). They suggest that, the relationship varies with firm-specific, owner-specific and government mechanisms in place. The mixed results between ownership concentration and firm value stimulate and encourage continuous debate on this subject.
This study argues that the works which report a positive relationship consider, in most cases, ownership concentration as the percentage of shares held by large shareholders combining ownership of several block holders such as top five, top three or the first two largest

shareholders. Previous literature contends that the presence of large multiple large shareholders is one of the ways to mitigate second-order agency costs, the conflict of interest between majority shareholders and minority shareholders. According to Gomes and Novaes (2005), Laeven and Levine (2008) and Maury and Pajuste (2005), combining the shareholdings of several block holders prevents some among them extracting private gain at the expense of the rest if the dispersion of shareholdings between the block holders is not so large. According to the authors, large block holders collectively monitor the behaviour of the corporate managers and it becomes relatively difficult for all block holders to collude with management in order to expropriate the interest of minority shareholders. This might be suggested as the reason for a positive relationship between ownership concentration and firm value reported in previous studies such as Jensen & Meckling (1976); Zeckhouser & Pound (1990); Xu and Wang , (1999); Burkart *et al*.(1997); Claessens *et al*. (2002) and Pedersen and Thomsen, (2000).

It may be argued that, a single controlling shareholder can easily collude with managers to further his own interests. Few studies report the ownership concentration as the percentage of the shares held by the largest shareholder such as Thomsen and Pedersen (2000) and most recently Faccio *et al.* (2011). The ownership concentration reported in the UK in this study is expected to harm the firm value. It is therefore hypothesised that;

Hypothesis One

The ownership concentration of the largest block holder is negatively related to firm performance.

7.2.2 Departure of Ownership from Control

Literature on ownership structure has currently emphasised the distinction between controlling shareholders' cash flow and control-rights. The divergence of the two rights is considered by some strands of the literature as the control-enhancing mechanism which exacerbates the extent of the conflict between controlling shareholders and minority shareholders (Shleifer and Vishny 1997, La Porta, Lopez-de-Silanes and Shleifer 1999; Bebchuk, Kraakman and Trianis 2000; La Porta *et al.* 2002; Becht, Bolton and Röell, 2005).

Literature define control-rights of ownership as shareholders' ability to control all key corporate decisions, while cash-flow rights refer to the proportion of the firm's excess cash flow to which a shareholder is entitled. If all other factors are kept unchanged, the larger the controlling owner's control-rights, the greater is the ability of such an owner to harm other non-controlling shareholders by pursuing their own private advantage (Johnson *et al*. 2000; Franks and Mayer, 2001; Nenova, 2003; Bertrand, Gugler and Yurtoglu , 2003 and Dyck and Zingales, 2004).

According to Jensen and Meckling (1976), however, as the cash-flow rights of the controlling owner increase, the incentive of the controlling owner coincides with other shareholders' incentives and hence the possibility of expropriation diminishes. Thus the conflict of interest between controlling shareholders and non controlling shareholders becomes more serious when the control-rights of the controlling shareholder depart significantly from cash-flow rights.

Theoretically it remains unclear as to whether the increase in the control-rights of the controlling shareholder affects the value of the firm negatively or positively. On the one

hand, the increase in control-rights creates more potential scope for expropriation by controlling shareholders and ultimately this harms the firm value. On the other hand, control-rights provide the controlling shareholder with the power to monitor corporate managers' selfish behaviour of extracting private benefits from corporate resources. To establish which effect dominates, between incentives alignment and expropriation is the subject matter of the empirical analysis which is the scope of this chapter.

However, what is not unclear is the impact of an increase in the controlling owner's cash-flow rights on firm value. Literature suggests that the increase in cash-flow rights of the controlling shareholder reinforces the incentives of the controlling shareholder to maximize the firm value as this action benefits them more. This study suggests that as the control rights of the largest block holder increases relative to the cash flow rights the value of the firm becomes in a trouble. It therefore follows from this discussion that:

Hypothesis Two

The control-ownership wedge of the controlling shareholder is negatively related to firm performance

7.2.3 Owners' identity and Corporate Performance

Several ownership studies focus on ownership concentration and results but its linkage with firm performance remains a puzzle. Very few studies address the extension of ownership to owner identity and the rarity of studies in this area is evidenced by Gugler (2001) in his book entitled '*Corporate Governance and Economic Performance'*. Literature suggests that in UK studies this line of research falls short. In their study, extending this line of research using the sample of continental Europe, Pedersen and Thomsen (2000) find that the identity of owners matters significantly. Their results reveal that companies whose main owners are institutions

perform better. The study also reports a negative relationship between government ownership and performance. When the relationship between concentrations of ownership by family was tested, Pedersen and Thomsen find an insignificant relationship.

Although previous literature such as Pound (1988), sees financial institutions as more active monitors of corporate managers than other investors, due to their wide knowledge and competence in financial management, they put more emphasis on a firm's liquidity and they don't establish a long-term relationship with the firm they deal with, instead they are inclined to take an exit strategy if the firm suffers a liquidity problem rather than putting effort into rescuing the situation. On the other hand, some other literature strands provide a contradictory view that non-financial institutions such as family companies holding larger stakes may also have specific industry expertise which is more effective than that of financial institutions, (see Allen and Phillips, 2000). Also, the authors claim that non-financial institutions may increase a firm's value by holding shares for long duration because long-term holdings reduce information asymmetry between firms involved in a joint venture.

Literature on family ownership provides evidence that families have a greater desire over control motives compared to any other group of corporate owners. It is clear that families have a long lasting commitment to the firm which goes beyond financial performance. According to Chami (1999) and Becker (1981), founding families do not consider their firm in terms of the cash it generates but rather they go beyond and are concerned with passing the ownership to future generations of family members. This motivates a family block holder to exercise control over a firm's decisions with extra concern as this has an impact on future generations.

According to Anderson and Reeb (2003), since most family block holders concentrate their investments in a few industries, they are exposed to relatively higher firm-specific/ industry-specific risk. To avoid such a risk, strong controls should be put in place. According to Anderson and Reebs (2003), although institutional block holders have their own motives for control, these are outperformed by family block holders who are always considered as active managers of the firm (as opposed to institutional block holders who, in the US and many other countries, are legally banned from sitting on the board of directors of the firm in which they have holdings).

In a similar vein, Tufano (1996) insists that institutional investors usually own a diversified portfolio of shares. Furthermore, Gillian and Starks (2000) and Karpoff (2001) both insist on the ineffectiveness of institutional investors in monitoring firms and claim that institutional investors' activism contributes little to change in a firm's governance. This leads one to conclude that the monitoring motives exerted by institutional block holders may be relatively weak compared to those exerted by family block holders which are capable of influencing firm value.

Furthering these arguments, Bubolz (2001) argue that institutional investors are driven by agency theory, as they act as agents of the firm, while family owners are governed by the stewardship motive where a manager's concerns go beyond economic self-interest. Many of them, according to the author, contribute to the firm's mission, longevity and selection of stakeholders. According Bubolz (2001) family owners have a deep emotional investment in the firms they control. Furthermore the prosperity of family firms, their personal fulfilment and public reputation are attached to the business.

However, because families have their own measures of personal fulfilment and the business is to be transferred from one generation to the next, family companies may protect their control and prevent outside investors diluting that control so that they maintain enough control to put in place their own managers, who are family members, after the retirement or death of the founders, to preserve the same values and culture which is to be transferred to the next generation.

Previous studies suggest family companies' superior performance by indicating that families have valuable knowledge about the businesses (Anderson and Reebs, 2003). However, this study suggests that the family business *founder* may have a sufficient knowledge about the business, but because the family may not be willing to employ an outside professional manager and prefer an insider family manager, the manager within the family who takes over from the founder may not be as knowledgeable as the founder. Due to the lack of managerial skills, insider managers in family firms may make managerial decisions which can jeopardize the corporate value.

This is supported by Morck *et al.* (2000) who find that heir-controlled companies perform poorly due the lack of sufficient management skills by heirs. Following the same line of argument, Pérez-González (2006) reports that inherited control is detrimental to firm performance, in particular when the heirs have not got good managerial training. Cronqvist and Nilsson (2003) also suggest that families can easily entrench and make unprofitable investments.

In the sample of firms used in this study, family firms are characterized as having more concentrated ownership than any other type of block holders. In fact the average family control-rights amount to about 42%. This is used as a control-enhancing mechanism for family companies. Furthermore it is found from the descriptive analysis that, of all the family controlled companies, about 78% are controlled by family managers.

It is doubtful that all these companies have better managers found within their own families than could have been employed from outside. This seems to suggest that internal managers are chosen to work in the family tradition and prepare the company to be handled over to the next generation.

It can be argued that external managers are professionally trained and may use their managerial skills to boost the firm performance. Hence, this study suggests that, those companies (which are generally widely held) which are controlled by professional managers are in a position to perform better than family-managed firms. These arguments result in the following testable implication:

Hypothesis Three

Manager-controlled firms have higher performance than family-controlled firms whose CEO is a family member.

7.2.4 Multiple Large Shareholders and Standalone Shareholder

Since the seminal work by Berne and Means (1932), several governance mechanisms in widely-held corporations have been suggested to protect the minority shareholders' interests from expropriation, such as monitoring from large shareholders and takeover threat. Most recently researchers have focussed on the influence of multiple large shareholders on firm value through reducing the conflict of interest between majority shareholders and minority shareholders. Laeven and Levine (2008) studying the role of multiple large shareholders on firm value, using the sample of listed companies in 13 European countries, find that the presence of multiple large shareholders prevents the expropriation of minority shareholders' interests by the largest shareholder because other shareholders - due to their significant stakes - can monitor the largest shareholder. This, as a result, protects the interest of the firm and increases the firm value.

On the other hand, Attig *et al.* (2009) investigate the impact of large shareholders on the interaction between a firm's value and free cash flows using a sample of 22 countries from East Asia and Western Europe, and they find that the presence of multiple large shareholders reduces the agency cost of free cash flows.

There also exist single country researches on the influence of multiple large shareholders on firm value. Belot (2008), Gutieres and Pombo (2009) and Maury and Pajuste (2005) using samples of French listed, Colombian listed and Finish listed firms respectively, all report the presence of multiple large shareholders having a positive effect on firm value. From previous studies it can be noted that there exist multiple large shareholders in the UK despite the traditional belief that the UK and the US have a generally dispersed ownership structure. In Laeven and Levine (2008) it is found that in a sample of 689 listed companies in UK 26.7% of firms have no controlling owner, 42.8% have one controlling owner while 30.5% of the sample represents companies with multiple large shareholders. According to La Porta *et al.* (1999) and Claessens *et al.* (2002) a firm is said to have multiple large shareholders if the largest shareholder owns more than 20 % of the shares while the second largest owner owns at least 10% of all quoted shares. Therefore it is interesting to find out whether the presence of large multiple shareholders in the UK impact on firm value.

Theoretically, according to monitoring effect, apart from the largest shareholder, the existence of other large shareholders with relatively large stakes creates an incentive for them to monitor the largest shareholder for the purpose of limiting him/her from extracting personal benefits. In so doing the interest of the minority shareholder is defended resulting in the maximization of the firm's value, La Porta *et al.* (1999). It therefore follows from this theory that:

Hypothesis Four

Firms with multiple large shareholders perform better than standalone companies

7.2.5 Size and Composition of the Control Coalition

Bennedsen and Wolfenzon (2000)' s model contends that a single shareholder does not have sufficient power to control the firm and therefore individual shareholders need to combine their voting powers, and, in such a case, before any decision is made, all shareholders must agree on the matter in hand. This makes it difficult for expropriation to take place and hence improves the overall firm performance.

According to Bennedsen and Wolfenzon, a coalition is formed by combining the voting rights of the larger shareholders to form a controlling group with voting rights above 50%. It is noted from Bennedsen and Wolfenzon that, in most cases the coalition with the smallest cash-flow rights wins among others during its formation. Therefore, the controlling group/coalition will have an incentive (small cash flow rights) and capability (sufficient voting rights) of expropriating the minority shareholders' interests. It can be recalled from Jensen and Meckling (1976) and Bennedsen and Wolfenzon (2000) that a controlling shareholder, in this case a winning coalition group, does not experience a large reduction of cash flow resulting from the divergence of corporate resources. This is referred to as *ex-post bargaining theory* according to Gomes and Novaes (2005).

It is realized from Novaes (2005) that, agreements on some issues, like policy change, which may bring private benefits to controlling shareholders, become more difficult as the number of members of the coalition increases. This may happen because some members may be less able to benefit from the deal; hence they may not choose to accept a particular decision at the

expense of the firm's efficiency, even though it might be in the collective interest of most of the group members.

According to Bennedsen and Wolfenzon (2000), the formation of a ruling controlling group is relatively hard if the members of the groups are not of the same type. More specifically, the collusion effect becomes more possible - meaning that the marginal cost of extracting private benefits seems to be lower for the controlling group where both the largest and the second largest block holder are family companies as opposed to a coalition group with the largest shareholder a family company and the second largest an institution especially a financial institution, Maury and Pajuste (2005). According to these authors, it is difficult for the largest overall shareholder, for instance a family company, to collude with financial institutions in an attempt to extract private benefits because this action becomes more costly if the deal is recognized and exposed.

This is more risky for financial institutions as the opportunity cost of being caught diverting firm's resources is higher for them since they are supervised by regulatory authorities. In relation to this argument one may argue that the firm with a controlling group having both the largest and the second largest shareholder with the same identity has more ability to facilitate personal benefit extraction compared to that firm whose largest shareholder and second largest are of different types. It follows therefore that:

Hypothesis Five

The firm with a controlling group having both the largest and the second largest shareholder with the same identity has lower firm value compared to that firm whose largest shareholder largest and second largest are of different types

7.3 Empirical Analysis and Results

7.3.1 Empirical Methods

This section examines the value effect of corporate ownership and control structures of 643 UK non-financial listed companies for the period between 1996-1999 using OLS estimation method. In particular the study assesses the value effect of the ownership concentration of the largest shareholder, the role of the second largest shareholder in monitoring the activities of the largest block holder, the effect of control-rights divergence from cash-flow rights on performance, the performance difference depending on different owners' identities, and performance effects on different potential coalitions formed by block holders of different types and with different voting power.

Ownership studies are commonly associated with the problem of endogenity where ownership and performance are determined together. To solve this problem, following Laeven and Levine (2008), like in Demsetz and Lehn (1985) and Bitler *et al.* (2005), we load the regression with a sufficient number of firm characteristics to capture as much of the error term as possible. Secondly, we compute the ownership data one year before Tobin's Q so as to reduce the possibility of short-term variations in performance which might influence ownership structure. This tends to imply a stronger assertion of causality. However, Faccio and Lang (2002) argue that, ownership fluctuates very slowly over time.

Similar to Maury and Pajuste, (2005), Pooled Ordinary Least Squares Regression specification (OLS) is employed to test whether ownership structure affects firm performance.

The model is specified as hereunder;

$$Q_{i,t} = \alpha + \beta_1 * OWN_{i,t-1} + \beta_2 * DT_{i,t-1} + \beta_3 * FSZ_{i,t-1} + \beta_4 * IR_{i,t-1} + \beta_5 * ATANG_{i,t-1} + \beta_6 * FCF_{i,t-1} + \beta_7 * SGR_{i,t-1} + e_{it}$$

Where;

$Q_{i,t}$ =Performance at time t

$OWN_{i,t-1}$ =Ownership and control variables e.g. % age of the share held by the Largest block-holder a year before Q, CFR/CTR a year before Q.

$FSZ_{i,t-1}$ =Firm Size a year before Q

$IR_{i,t-1}$ =Investment Ratio a year before Q

$DT_{i,t-1}$ =Leverage a year before Q

$FCF_{i,t-1}$ =Free Cash Flows a year before Q

$SGR_{i,t-1}$ =Sales Growth Rates a year before Q

7.3.2 Empirical Results

7.3.2.1 Ownership Concentration, Control and Separation between the two

To examine the impact of ownership concentration and control on firm performance, a pooled OLS regression of 643 UK non-financial listed companies between 1996-1999 is run to include both ownership concentration and control concentration. In addition to ownership and control concentration, we employ a dummy variable which is equal to 1, if the control-rights for a particular firm are above the median and 0 otherwise. This dummy variable is interacted with control–rights variable. This interactive dummy is introduced, as in Claessens *et al.* (2002), to control for those corporations with highly concentrated control in the hands of a single controlling shareholder.

Model 1 in Table 7.3 shows that ownership concentration by the largest controlling block holder is negatively related to firm performance. This finding is contrary to the results of Claessens *et al.* (2002) who report a positive relationship.

It is suggested by this study that, at higher ownership concentration levels, where there is potential risk of expropriation by controlling shareholders, the firm value tends to decrease significantly. The decrease is reported in model 1 to be statistically significant at 5% significant level. Similar results are reported also for Germany where majority-controlled firms extract private benefits at the expense of minority shareholders as recorded by Gugler and Yurtoglu (2003) .This amounts to what literature terms *divergence of interest hypothesis* as emphasised by Shleifer and Vishny (1997) – namely that dominant shareholders extract private benefits from corporate resources using the control they have over the minority shareholders, thus denying the rights of minority shareholders to equally enjoy their share of corporate profit.

The degree of control-rights of the largest block holder is also reported to be negatively related to firm performance - consistent with Claessens *et al.* (2002) suggesting that, like concentration of cash-flow rights, higher concentration of control-rights leads to expropriation of minority shareholders.

To examine the hypothesis on divergence of cash-flow rights from control-rights, pooled OLS regression, which includes the ratio of cash-flow rights to control-rights, and interactive dummies controlling both the majority share ownership and disperse share ownership are employed. Regression results in model 2 in Table 7.3 show a negative and strongly statistically significant relationship between control-ownership wedge and firm performance.

This confirms the contention that it is the deviation of control from cash-flow rights which is associated with expropriation and which leads to the negative effect of separation of ownership from control on corporate performance.

7.3.2.2 Manager-Controlled and Family-Managed firms

The analysis in this subsection starts by testing the mean difference of performance between manager-controlled firms and family-managed firms. Manager-controlled firms in this study are defined as those non-family firms with ownership level below 10% managed by professional managers. On the other hand, family-managed firms are those family firms whose CEO/manager is a family member. Table 7.1 reports the results that manager-controlled companies perform better than family-managed firms. The difference in mean performance between the two groups of companies is statistically significant at 1% significant level.

This may support the view that the managerial position in family firms is a matter of inheritance, and because of the desire to maintain control in family hands and pass on the business to the next generation, the successor to the retiring or deceased CEO comes from within the family, even though no member in the family has the requisite level of management skills. On the other hand, in companies controlled by professional managers, the best managers are employed and the firms with the best professional managers perform better as reflected in the results presented in Table 7.1.

To get more insight into the performance difference between manager-controlled firms and family-managed firms, OLS regression is run and the results presented in Table 7.2. In doing so, the dummy variable on manager-controlled firms is created and interacted with the ownership of the largest sharereholder. Similarly, the dummy of family–managed firms is created and interacted with the ownership of the largest sharereholder. Model 3 in Table 7.3

shows that the ownership of the largest shareholder in manager-controlled firms is positively related to firm performance. The relationship is reported to be statistically significant at 5% significant level. On the other hand, the relationship between the ownership of the largest shareholder in family-managed firms is negative and statistically significant at 5% significant level.

These findings confirm the suggestion that external managers who are professionally trained can use their managerial skills to boost firm performance, as opposed to managers chosen from within the family, who might lack the relevant managerial skills, as stated by Morck *et al.* (2000) who find that heir-controlled companies perform poorly due to the lack of appropriate management skills by heirs. Similar findings are reported by Pérez-González (2006) and Bennedsen *et al.* (2007) who suggest that inherited control is detrimental to firm performance in particular when the heirs do not have good managerial training. The results are also supported by Villalonga and Amit (2006), as they put it: "*When family firms are run by descendant-CEOs, minority shareholders in those firms are worse off than they would be exposed to the classic agency conflict with managers.*

7.3.2.3 Presence of Multiple Large Shareholders

To test the hypothesis that companies with multiple large shareholders have better performance than standalone companies, the test of mean performance difference between the two groups of companies is performed. Table 7.1 reports the results which confirm that companies with multiple large shareholders have higher performance (higher Q) than standalone firms. The mean Q difference between these companies is reported to be statistically significant at 1% significant level. The possible reason for this differential performance is suggested to be the monitoring role of the other large shareholders imposed on the largest shareholder as opposed to companies without multiple large shareholders

where all corporate control rests on the hand of the largest shareholder, hence jeopardizing the corporate value through private benefit extraction by the largest shareholder.

A further test is conducted to see whether firms with multiple large shareholders and small deviation of cash-flow rights have higher performances compared to firms with multiple large shareholders and large deviation of cash-flow rights. Table 7.1 reports a statistically significant difference in performance at 5% significant level between the two groups of companies. It is observable that firms with multiple large shareholders and small deviation of cash-flow rights perform better than firms with multiple large shareholders and large deviation of cash-flow rights. These findings are consistent with those reported by Laeven and Levine, (2008) who confirm the similar results and suggest that, "*it is inappropriate to categorize firms with multiple block holders as either widely-held or as having a single controlling owner"*

Table 7.1 Univariate Tests on Firm Performance

In this table, the mean value of Q between companies with multiple large shareholders (MLS) and standalone companies (STANDALONE) are compared using standard t-tests on means. The comparison is also made for companies with multiple large shareholders having lower control-ownership wedge (MLS_{LC}) and those with higher control-ownership wedge (MLS_{HC}).Also the comparison is performed between Manager-controlled firms (MGR) and Family-controlled firms. Information from Worldscope and firms' annual reports for the period 1996-1999 is used to build the values of Q. *, ** and *** stand for statistically significant at 10%, 5% and 1% respectively, NS stands for Not statistically significant

Variable	MLS VS. STANDALONE	MGR VS. FAM-CTRLED	MLS_{HC} VS. MLS_{LC}
Q	2.83***	1.72**	2.51**

To test the hypothesis that companies with multiple large shareholders perform better than stand-alone companies, the test of mean performance difference between the two groups is performed. Table 7.1 reports the results, which confirm that companies with multiple large shareholders have higher performance (higher Q) than stand-alone firms. The mean Q difference between these companies is reported to be statistically significant at 1% significant level. The possible reason for this differential performance is suggested to be the monitoring

role of the other large shareholders imposed on the largest shareholder as opposed to companies without multiple large shareholders where all corporate control rests in the hands of the largest shareholder, hence jeopardizing corporate value through private benefit extraction by the largest shareholder.

A further test is conducted to see whether firms with multiple large shareholders and small deviation of cash-flow rights have a higher performance than firms with multiple large shareholders and large deviation of cash-flow rights. Table 7.1 reports a statistically significant difference in performance at 5% significant level between the two groups of companies. It is observable that firms with multiple large shareholders and small deviation of cash-flow rights perform better than firms with multiple large shareholders and large deviation of cash-flow rights. These findings are consistent with those reported by Laeven and Levine, (2008) who post similar results and suggest that, "*It is inappropriate to categorize firms with multiple block holders as either widely-held or as having a single controlling owner*

The mean performance difference test results are supported by the OLS results presented in Table 7.2. Model 4 shows that there is greater value reduction in companies with single controlling shareholders than in companies with multiple large shareholders. The relationship between the ownership of the largest shareholder and performance, for both groups of companies, is reported to be negative but it is more statistically significant for companies with a single controlling shareholder than it is for companies with multiple large shareholders. While the relationship is statistically significant at 5% significant level for companies with single controlling shareholders, it is marginally significant at 10% significant level for companies with multiple large shareholders. The results confirm the view that the presence of other large shareholders helps to reduce the ability of the largest shareholder to expropriate the interests of minority shareholders.

Finally, all models in Table 7.2 show a consistent relationship between firm performance and firm characteristics or control variables. It is consistently shown, with slight deviations, that, relationship between firm size and firm value is negative and statistically significant at 5% significant level, except in model 1 where the performance has an insignificant relationship with firm size. The reults further show that leverage has a positive and statistically significant relationship on performance. The relationship is reported to be strongly statistically significant at 1% significant level in all models. Similarly, the relationship between dividend yield and performance is reported to be negative and strongly statistcally significant at 1% significant level in all all four regression models as reported in Table 7.2. The table also reports a strongly statistically significant (at 1% statistically significant) positive relationship between growth opportunities and firm performance, consistent with Lang and Stulz (1994).

It can generally be argued that, companies with higher growth opportunities need more funding to explore the available investment opportunities.These companies will have to borrow more from markets to acquire the required cash for such opportunities. Such companies will not be in a position to pay dividends, which is reflected by a negative coefficient of dividend yield. If more growth opportunities are explored, the firm expands leading to firm performance improvement.

Table 7.2.OLS models: Performance and Ownership and Control Structures

This table presents OLS regressions reporting the effect of ownership and control concentration on firm performance. The dependent variable is Tobin's Q. The regressions include the cash-flow rights (CF-RIGHTS),control-rights (CTRL-RIGHTS) and control-rights above the mean (HICTRL); (MODEL 1), control-ownership wedge (CFR-CR), Majority ownership (MAJ) and widely held ownership (WH);(MODEL 2), ownership of the largest shareholder for manager-controlled firms (MGTCFR) and ownership of the largest shareholder for family-managed firms (FMCFR); (MODEL 3), ownership of the largest shareholder for firms with multiple large shareholders (MLS) and ownership of the largest shareholder for firms with single controlling shareholder (SINGLE); (MODEL 4). Control variables include Firm size (log (Total assets)), Investment ratio (the ratio of capital expenditure to assets), and the ratio of total debt to assets (Leverage). * Stands for significant at 10%; ** at 5%; *** significant at 1%.

DEPENDENT VARIABLE – PREFORMANCE (Q)				
Indep: Variable	MODEL 1	MODEL 2	MODEL 3	MODEL 4
CF-RIGHTS	-0.0072**(-2.13)			
HICTRL	-0.1005*(-1.87)			
CFR-CR		-0.1865*(-1.73)		
MAJ		-0.1868* (-1.73)		
WH		0.0106 (0.16)		
MGTCFR			-0.005**(-2.44)	
FMCFR			0.035**(2.04)	
SINGLE				-0.0044**(-2.18)
MLS				-0.0028*(-1.65)
SIZE	0.002(0.35)	-0.0289** (-2.00)	-0.041**(-2.52)	-0.0294**(-2.04)
LEV	0.0035***(2.82)	0.0073*** (3.22)	0.007***(2.97)	0.0072***(3.19)
DIV	-0.0279***(-4.64)	-0.0703*** (-6.43)	-0.073***(-6.33)	-0.0690***(-6.41)
IR	0.1098***(3.95)	0.0229*** (5.28)	0.022***(4.95)	0.0233***(5.35)
CONSTANT	0.8156***(12.66)	1.2906*** (8.34)	1.115***(10.31)	1.2089***(10.93)
R^2	0.127	0.190	0.182	0.187
F-stat	8.49***	14.19***	14.78***	15.47***
Observations	513	584	455	584

7.3.2.4 Size of Controlling Group

To examine the corporate control contestability, the number of large shareholders of each controlling group in the entire sample is identified by grouping companies into three different groups: companies with a single block holder with over 50% of corporate equity, companies with only two large shareholders controlling over 50% of corporate equity, and companies whose control is shared by more than two block holders. To compare performances of these companies, a t-test of mean difference between the groups of companies is conducted and the results are reported in Table 7.3. The results show that companies with controlling groups composed of more than two larger block holders have the highest performance (1.04) followed by those companies whose control is shared between two largest block holders (0.845) and the poorest performing companies are those with a single controlling shareholder.

To test whether there is a significant difference between each pair, the t-test presented in Table 7.3 shows that the mean performance difference between companies with controlling groups having more than two members and those with only two members is statistically significant at 5% significant level, while the performance difference between companies whose control coalitions are composed of only two large block holders, and those whose control rests wholly in a single block holder's hands is statistically significant at 5% significant level. The mean performance difference is more statistically significant (significant at 1% significant level) when companies with single controlling shareholders are compared with companies whose control is shared among more than two block holders.

These results support the contention that the size of the controlling group has a significant effect on firm performance. Controlling groups with more members are not likely to be easily linked with expropriating minority shareholders' interests compared to companies with fewer members in a controlling group.

These results are consistent with the disagreement effect, where agreements on R&D-intensive long-term projects are more difficult to achieve when there is great heterogeneity among block holders that have to take the decision. That is, conflicting voices are likely to be present when there is risk and investment horizons heterogeneity among owners (Hoskisson *et al.* 2002). According to the authors as the number of shareholders increases (the share ownership is more dispersed), managerial discretion goes up and risk-averse managers allocate resources away from risky projects which may harm firm value.

7.3.2.5 Composition of Controlling Group

To examine the pattern of complex ownership structures across firms, information on the identity of the multiple large shareholders with no single block holder owning more than 50%, as in Laeven and Levine (2008), is utilized. The focus is on the first two largest shareholders because in less than 10% of all cases in the sample firms used in this study, the third larger shareholder holds at least 5% of the corporate shares. Although there are other block holders apart from family block holders, families compose the greater proportion of large shareholders.

About 67% of all companies with multiple large shareholders, without any single controlling shareholder, are companies whose largest shareholder is a family company. It is also reported that in about 61% of all the cases both the two largest block holders are families and in around 57% the largest block holder is a family while the second largest is a widely-held financial institution. Furthermore, the analysis reveals that, in only 28% of all the cases, both the top two block holders are widely-held financial institutions with only 24% (34) having the largest shareholder being a widely-held financial institution and the second largest a family company.

The analysis starts by testing performance mean difference between companies whose largest and second largest block holders are families, and those companies with the largest block holder a family and the second largest a widely-held financial institution. The results presented in Table 7.3 show that companies with two family stakeholders in their controlling group perform better than those companies whose largest share holder is a family and the second largest a widely-held financial institution. The performance difference between the two corporate groups is statistically significant at 5% significant level.

The results support the collusion effect view proposed by Maury and Pajuste (2005) which states that the marginal cost of extracting private benefits is lower for the controlling group comprising of the first largest shareholder as family company and the second largest as family company, compared to a coalition group with the largest shareholder a family company and the second largest an institution. The lower the cost of extracting private benefits, the higher is the potential for expropriation which impairs the corporate value. This may be suggested as the possible reason why companies with two families in their controlling groups are associated with poor firm performance relative to those companies whose largest share holder is a family and the second largest a widely-held financial institution.

Table 7.3 Univariate Tests On the performance for size of the corporate controlling group and on performance of manager controlled and family controlled corporations.

This table compares, using standard t-tests on means, the difference in mean Q values between (a) companies where control is on a single block holder's hand and those companies where a controlling group is formed by two block holders; (b)companies where control rests on a single block holder's hands and those companies in which the controlling group is formed more than two block holders (c) companies where controlling group is formed by two block holders and those companies in which the controlling group is formed more than two block holders; (d) companies where top two largest block holders are "families" and companies whose largest block holder is a family and the second largest a financial institutions. Information from Worldscope and firms' annual reports for the period 1996-1999 is used to build the values of Q. *, ** and *** stand for statistically significant at 10%, 5% and 1% respectively

Variable	Single block holder Against Two block holders	Single block holder Against More than Two block holders	Two block holders Against More than two block holders	FAM-FAM Against FAM-FIN.IST
Q	-1.98**	-3.06***	-1.87**	-1.68*

To get more insight into the composition of the corporate control coalition, a partial correlation of six different dummies on the identities of the largest and the second largest shareholders with the dispersion of cash-flow rights between the largest and the second largest block holders was carried out. The results in Table 7.4 show that there is no correlation between cash flow-rights dispersion and family ownership of either the largest or

the second largest neither is there a correlation between cash flow-rights dispersion and institution ownership of either the largest or the second largest.

These findings highlight the need to consider the identity of the second largest shareholder in the control coalition. In Table 7.4, it is shown that the correlation between the dummy variable which represents the combination of the largest family block holder and the second largest family block holder, there is a negative and statistically significant relationship at 5% significant level while the correlation becomes positive and statistically significant at 10% significant level when the second largest shareholder is changed to be a widely-held financial institution.

It may be recalled from the theoretical part of this study that the more the dispersion of cash-flow rights between the largest and the second largest block holders, the higher is the possibility of the largest shareholder taking control of corporate decisions as suggested by Maury and Pajuste (2005). The results of partial correlation are consistent with the results in Table 7.4 which tests the mean performance difference between the two groups of companies with both the largest and second largest block holders, because companies with families as the largest and second largest shareholders in Table 7.4 have a negative correlation with cash-flow rights dispersion which implies that they have the potential for expropriation resulting in lower value as shown in Table 7.4.

Table 7.4 Partial correlations between Dummies for the identities of the largest and the second largest shareholders with cash-flow rights dispersion

Partial Correlation of Dispersion of Cash-flow rights with;	Correlation	P-value
Dummy Family is the Largest Shareholder	-0.0347	0.678
Dummy Family is the Second Largest Shareholder	0.0423	0.612
Dummy Widely held financial is the largest shareholder	-0.0526	0.528
Dummy Widely held financial is the second largest shareholder	0.0735	0.378
Dummy Both the largest and the second largest are Families	-0.18**	0.030
Dummy Family is the Largest shareholder and Widely held financial the second largest	0.153*	0.065

7.4 Sensitivity Analysis

To ensure that the presented results are truly of ownership and control and are not driven by industry effect, the performance of each firm is regressed against ownership and control and controlled for industry. More importantly, I show that the documented performance differences are not due to industry effect. To confirm this, pooled OLS regressions are re-estimated including the industry dummies and the results remained unchanged as reported in Table 7.5. In This study the large shareholder is defined as an investor holding at least 10% of corporate shares. The study also re-estimated all models using alternative control thresholds such as 20%, 25% and 33% and the results (not reported) qualitatively remained unchanged.

In this study a family firm includes an identified family, an individual or a firm which is not listed on any stock exchange. To ensure that the results of the study are not affected by the definition used, the model is re-estimated to include only identified family. The regression coefficients maintained the same signs and remained statistically significant although the level of significance slightly changed.

Finally, the accounting-based performance measure (ROA) is employed as an alternative of the market-based performance measure (Tobin's Q), used in this study. The regression estimates remained qualitatively unchanged in almost all models except for the multiple large shareholder (MLS) model, model 4, where the coefficient's sign remained negative but the statistical significance disappeared as reported in Table 7.6.

Table 7.5.OLS models: Performance and Ownership and Control Structures

This table presents Pooled OLS regressions reporting the wealth effect of ownership and control concentration. The dependent variable is Tobin's Q. The regressions include the cash-flow rights (CF-RIGHTS),control-rights (CTRL-RIGHTS) and control-rights above the mean (HICTRL); (MODEL 1), control-ownership wedge (CFR-CR), Majority ownership (MAJ) and widely held ownership (WH);(MODEL 2), ownership of the largest shareholder for manager-controlled firms (MGTCFR) and ownership of the largest shareholder for family-managed firms (FMCFR); (MODEL 3), ownership of the largest shareholder for firms with multiple large shareholders (MLS) and ownership of the largest shareholder for firms with single controlling shareholder (SINGLE); (MODEL 4). Controls variable include Firm size (log (Total assets)), Investment ratio (the ratio of capital expenditure to assets), and the ratio of total debt to assets (Leverage).. Industry dummies are included in the models and reported as INDUMMY. * Stands for significant at 10%; ** at 5%; *** significant at 1%.

DEPENDENT VARIABLE – PREFORMANCE (Q)				
Indep: Variable	MODEL 1	MODEL 2	MODEL 3	MODEL 4
CF-RIGHTS	-0.0062**(-1.99)			
HICTRL	-0.165*(-1.78)			
CFR-CR		-0.1665*(-1.83)		
MAJ		-0.1768* (-1.86)		
WH		0.0006 (0.26)		
MGTCFR			-0.015**(-2.15)	
FMCFR			0.035**(2.34)	
SINGLE				-0.0341**(-2.09)
MLS				-0.0128*(-1.76)
SIZE	0.002(0.45)	-0.0289** (-2.00)	-0.341**(-2.62)	-0.0247**(-2.14)
LEV	0.0135***(2.61)	0.0073*** (2.67)	0.017***(2.78)	0.0412***(2.89)
DIV	-0.0379***(-4.24)	-0.0703*** (-5.53)	-0.073***(-5.37)	-0.0760***(-5.11)
IR	0.1198***(2.95)	0.0229*** (4.18)	0.0234***(5.95)	0.0251***(4.35)
CONSTANT	0.8756***(10.66)	1.2906*** (9.34)	1.105***(9.31)	1.227***(9.93)
R^2	0.156	0.187	0.172	0.197
F-stat	7.59***	12.19***	11.78***	12.37***
INDUMMY	Yes	Yes	Yes	Yes
Observations	513	584	455	584

Table 7.6.OLS models: Performance and Ownership and Control Structures

This table presents Pooled OLS regressions reporting the effect of ownership and control concentration on firm performance. The dependent variable is ROA. The regressions include the cash-flow rights (CF-RIGHTS),control-rights (CTRL-RIGHTS) and control-rights above mean (HICTRL); (MODEL 1), control-ownership wedge (CFR-CR), Majority ownership (MAJ) and widely held ownership (WH);(MODEL 2), ownership of the largest shareholder for manager-controlled firms (MGTCFR) and ownership of the largest shareholder for family-managed firms (FMCFR); (MODEL 3), ownership of the largest shareholder for firms with multiple large shareholders (MLS) and ownership of the largest shareholder for firms with single controlling shareholder (SINGLE); (MODEL 4). Controls variable include Firm size (log (Total assets)), Investment ratio (the ratio of capital expenditure to assets), and the ratio of total debt to assets (Leverage). Industry dummies are included in the models and reported as INDUMMY. * Stands for significant at 10%; ** at 5%; *** significant at 1%.

DEPENDENT VARIABLE – PREFORMANCE (ROA)				
Indep: Variable	MODEL 1	MODEL 2	MODEL 3	MODEL 4
CF-RIGHTS	-0.0762**(-1.90)			
HICTRL	-0.0321*(-1.79)			
CFR-CR		-0.1665*(-1.93)		
MAJ		-0.1768* (-1.99)		
WH		0.0056 (0.56)		
MGTCFR			-0.065**(-2.75)	
FMCFR			0.023*(1.98)	
SINGLE				-0.0341**(-2.08)
MLS				-0.0134(-1.46)
SIZE	0.062(0.18)	-0.0447* (-1.95)	-0.041**(-2.62)	-0.0274**(-2.24)
LEV	0.0135***(2.61)	0.0013** (2.22)	0.0071**(2.28)	0.0072***(2.79)
DIV	-0.0379***(-4.24)	-0.0403*** (-3.63)	-0.0173*(-1.97)	-0.0760***(-3.91)
IR	0.1008***(2.95)	0.0219*** (4.28)	0.062***(5.95)	0.0273***(3.85)
CONSTANT	0.8120***(6.69)	1.2106*** (2.34)	1.143***(4.31)	1.2089***(7.24)
R^2	0.166	0.159	0.142	0.157
F-stat	7.59***	11.19***	17.78***	19.47***
INDUMMY	Yes	Yes	Yes	Yes
Observations	513	584	455	584

7.5 Chapter Summary and Concluding Remarks

To examine the impact of ownership concentration and control on firm performance, a pooled OLS regression is run to include both ownership concentration and control concentration.
It is found that both ownership and control concentrations by the largest controlling block holder are negatively related to firm performance, suggesting expropriation of minority shareholders, which is unfavourable to corporations because it impacts negatively on corporate values as reported by Claessens and Djankov (1999). It is suggested by this study that, at higher ownership concentration levels, where there is potential risk of expropriation by controlling shareholders, the firm value tends to decrease significantly.

The examination of deviation of control rights from cash flow rights shows a negative and statistically significant relationship between control-ownership wedge and performance. This confirms the contention that the deviations of control from cash flow rights are associated with expropriation, which leads to the negative effect of separation of ownership from control on corporate performance.

OLS regressions further report a positive relationship between the ownership of the largest shareholder and performance in manager-controlled businesses, and a negative relationship in family-managed firms. These findings confirm the contention that external managers – being professionally trained - use their managerial skills to boost a firm's performance, as opposed to managers chosen from within the family, who might lack sufficient managerial skills as insisted on by Morck *et al.* (2000) who find that heir-controlled companies perform poorly due to the lack of sufficient management skills by heirs.

These results are also supported by Villalonga and Amit, (2006) who state, in their own words "*When family firms are run by descendant-CEOs, minority shareholders in those firms are worse off than they would be exposed to the classic agency conflict with managers"*

To test the hypothesis that companies with multiple large shareholders perform better than stand-alone companies, the test of mean performance difference between the two groups of companies is performed, and the results confirm that companies with multiple large shareholders show better performance than stand-alone companies. Among the companies with multiple large shareholders, those having lower control-cash flow rights deviation perform better than those with large deviation. These findings are consistent with those reported by Laeven and Levine (2008) who confirm similar results. The possible reason for this differential performance is suggested to be the monitoring role of the other large shareholders imposed on the largest shareholder, as opposed to companies without multiple large shareholders where all corporate control rests in the hands of the largest shareholder.

The study also reports the impact of the size and composition of the corporate controlling group. Regarding the size of the controlling group, the results show that companies with controlling groups comprised of more than two larger block holders perform better than those companies whose control is shared between two largest block holders and those with a single controlling shareholder. These results support the contention that the size of the controlling group has a significant effect in corporate decision-making which ultimately affects a firm's performance. Controlling groups with more members are less likely to be involved in expropriation than those with fewer members.

The results are consistent with disagreement effect where agreements on R&D-intensive long-term projects are more difficult to achieve when there is a great heterogeneity among block holders who have to take the decision. That is, conflicting voices are likely to be present when there is risk and investment horizons heterogeneity among owners (Hoskisson *et al.* 2002).

Furthermore, the study examines the composition of the controlling group by testing performance mean difference between companies whose largest and second largest block holders are families, and those companies with the largest block holder a family and the second largest a widely-held financial institution. The results show that, companies with two families in their controlling group have lower performance compared to those companies where the largest shareholder is a family and the second largest, a widely-held financial institution.

These results support the collusion effect view proposed by Maury and Pajuste (2005) that, the marginal cost of extracting private benefits is lower for the controlling group where both the largest and second largest shareholder are family companies compared to the coalition group with the largest shareholder a family company and the second largest an institution. The lower the cost of extracting private benefits, the higher is the potential for expropriation, which impairs the corporate value. This may be suggested as the possible reason why companies with only families in their controlling groups are associated with poor firm performance relative to those companies whose largest shareholder is a family and the second largest a widely-held financial institution.

It has been consistently reported, in this chapter, that control variables relate to performance more statistically stronger than ownership and control variables. This may bring a sense that control variables explain corporate value better than control rights and cash flow rights. It is

strongly suggested that, the explanatory power of control and cash flow rights may have been limited by the use of the weakest link principle employed by Faccio and Lang (2002) to measure their values. The researcher believes that, had it not been for the use of this principle the relatively better relationship would be reported. Therefore, a fair interpretation of these results needs a clear consideration of the limitations and weaknesses described in the methodology section of this study (chapter four).

CHAPTER EIGHT

8.0 CONCLUSIONS, LIMITATIONS, RECOMMENDATIONS AND POLICY IMPLICATIONS

8.1 Conclusions

This chapter re-presents the discussions and summarises the important conclusions made in this thesis. The study argues that corporate ownership structure may be used as a governance device to ensure corporate financial decisions and policies are made with a view to maximizing the wealth of shareholders. Ownership and control structures may also be used to support unfavourable financial and dividend decisions which ultimately impact negatively on the wealth of corporate owners. In essence, this chapter discusses the ways in which ownership and control structures influence corporate financial policies and ultimately performance.

The first interesting results to emerge from this study are the broader UK corporate ownership characteristics: about 47% of sampled firms are controlled by ultimately held companies at 10% threshold while 53% are firms owned by widely-held companies. It is further reported that only 25% of ultimately owned companies are controlled by widely-held financial institutions, while 65% of the control of ultimately owned companies rests in the hands of families. This provides direct preliminary evidence that the agency problem between majority and minority shareholders in UK listed companies is becoming severe, when compared to in the 1980's where most companies were widely held and the core agency problem was between managers and shareholders.

In assessing the impact of corporate ownership and control on financial policies and ultimately on performance, a regression analysis was performed. The study starts by

considering the impact of corporate leverage on ownership and control. The study confirms a negative relationship between ownership concentration and debt. The empirical results are reported to be inconsistent with Jensen's (1986) free cash flow hypothesis that debt limits expropriation, but are in line with the hypothesis that debt facilitates minority shareholders' expropriation.

According to the expropriation hypothesis, a company with a higher deviation of control rights from cash flow-rights attracts higher leverage. This is because the controlling block holders do not fear the risk related to bankruptcy as they directly own a smaller proportion of corporate shares, so that, in the event of bankruptcy, they do not lose much. Due to greater voting power, which they accumulate through indirect ownership (via mechanisms such as pyramiding and dual-class equity) controlling shareholders may influence more debt and use it to explore projects in their own interests in an attempt to extract benefits, which do not accrue to other shareholders. In practice, minority shareholders and external debt providers, it is argued, become more careful about loans undertaken by companies whose ownership and control are highly separated, as this separation signals a greater exposure to expropriation by the controlling shareholders.

Jensen's hypothesis takes for granted that debt-holders monitor management and it overlooks the fact that controlling shareholders might also have significant control over financial institutions that provide loans. It is, therefore, hardly credible to suggest that the controlling shareholder can use debt to monitor himself. In the UK, based on the sample used in this study, 25% of controlling shareholders are financial institutions. This suggests that these block holders may have control over the provision of loans in their institutions and can, therefore, easily facilitate offering huge loans to companies in which they have financial interests. Thus, debt may not be used as a monitoring device but rather as an expropriation device.

It may be argued that companies with higher voting rights of the largest shareholder have more potential for expropriating the interests of minority shareholders, by issuing more debt, and using it to fund projects of their own interests, or for some other private use. While those companies with lower voting rights, or higher cash flow-rights, avoid higher debts as potential bankruptcy, which may result from applying higher debt, can affect the substantial investments they make in the company. On the other hand, block holders with higher voting rights are less concerned about bankruptcy because their exposure to loss is not very significant when the firm fails since their cash-flow rights are not especially large.

Higher debt ratios ultimately result in a potential decrease in corporate value. Therefore, one can argue that the increase in voting rights of the controlling shareholder leads to an increase in corporate leverage which potentially results in bankruptcy, in extreme cases. This ultimately affects the firm's performance negatively.

Furthermore, dividend is considered as a corporate governance device to prevent companies misusing shareholders' assets. When the company has excess cash flow, its distribution as dividends is considered to be a control mechanism for the misuse of excess cash flows as suggested in Jensen's free cash flow hypothesis. Therefore, a company which pays more dividends is considered to be free from expropriation in the eyes of shareholders, but a company which retains excess cash flows signals the existence of agency conflict between controlling shareholders and minority shareholders.

Regarding the impact of control concentration on dividend policy, the study reports a negative and significant relationship between dividend ratio and the voting rights of the largest shareholder. The regression results support the contention that the higher voting rights grant the largest shareholder incentives (lower cash-flow rights) and ability (higher control-rights) to extract private benefits, by utilizing the corporate excess cash flows in projects of

their own interest which do not benefit other smaller shareholders. Therefore, higher control-rights result in lower dividends. Corporations which pay lower dividends are subject to value discount.

The study further examines the relationship between voting rights of the largest shareholder and firm performance. It is found that voting rights of the controlling shareholder are negatively related to firm performance. This suggests that when controlling shareholders have excess voting power, they utilize it to influence some projects which benefit themselves at the expense of the minority shareholders. Or they may use their voting power to extract private benefits through related party transactions. This results in the expropriation of minority shareholders, which is unfavourable to corporations, because it tends to discount shareholders' wealth.

The reduction of corporate value becomes even more severe when corporate ownership and control are separated. It is reported that most UK corporations employ control-enhancing mechanisms such as pyramidal and dual-class equity structures to accumulate control by separating ownership from control. While 31% of all sample firms use pyramidal structures to separate cash-flow rights from control-rights, 26% employ dual-class equity structures. This preliminarily confirms the expropriation of minority shareholders due to deviation between cash flow and control-rights.

When the effect of the control-ownership wedge on corporate leverage was examined, the results show that as the deviation decreases, the debt ratio decreases and when the deviation increases there is an increase in debt ratio. This finding supports directly the expropriation hypothesis offering evidence for the debt-increasing effect. As previously discussed, as the debt ratio increases, the firm value decreases, hence it directly implies that when the deviation between control-rights and cash-flow rights increases there is a decrease in firm value.

The results of this study reveal that while companies with higher control-ownership wedge have more potential to expropriate the interests of minority shareholders, by cutting dividends and retaining more cash for their private deals, those companies with higher control-ownership wedge have an incentive to pay more dividends because they expect a higher proportion of corporate profits, as they have relatively higher cash flow rights. Since payment of dividends leaves a company with less or no free cash flow, then the company may increase its borrowing capacity which may subject it to bankruptcy risk. In this case, companies which pay more dividends use more debt in their capital structures.

When the relationship between control-ownership wedge and firm performance is tested, the results show a negative and statistically significant relationship. This confirms the contention that the deviations of control from cash-flow rights are associated with corporate assets misuse, which leads to the negative effect of separation of ownership from control on corporate performance.

Regarding the impact of the largest shareholder's identity on corporate financial decisions, the study focuses on the two major groups of firms with controlling shareholders namely, widely-held financial institutions and family companies. The two groups comprise over 40% of the whole sample. This study reports that companies controlled by families have higher debt ratios than companies controlled by financial institutions. This is an indication that when companies controlled by families need external finance, they prefer not to issue equity and instead opt for debt. The first possible reason for this, as suggested by some strands of the literature such as Ellul (2008), may be fear of diluting their control by introducing more equity holders and, therefore, the debt is used by family companies as a control-enhancing mechanism. Another reason for this choice may be protecting their firms from take-over threats as highlighted in Harris and Raviv (1988), and Stulz (1988).

It may be argued that family companies are reluctant to invite on board other block holders such as professional and knowledgeable external shareholders (like financial institutions) to avoid the challenge that might be posed by such external players on the family management structure and *modus operandi*. The absence of strong external monitors makes it easy for family companies to pass control and management to the next generation without any resistance, even if the heirs do not have the requisite management skills. This is suggested to be the reason why family companies perform relatively worse than companies where management positions are not inherited.

The regressions result reports a positive relationship between ownership of the largest shareholder and performance in manager-controlled and a negative relationship in family-managed firms. These findings confirm the suspicion that external managers, being professionally trained, may use their managerial skills to boost the firm's performance unlike managers appointed from within the family, who might lack sufficient managerial skills. This is also insisted on by Morck *et al.* (2000) who find that heir-controlled companies perform poorly due the lack of sufficient management skills by heirs. Similar results are also reported by Villalonga and Amit (2006).

The examination of corporate ownership and control structures reveals that about 55% of the sample firms used in this study have no multiple large shareholders (companies with stand-alone controlling shareholders) such that there is only a single shareholder with corporate equity ownership of at least 10%. In assessing corporate control dilution, the study identifies firms whose largest owners control less than 50% of corporate shares. It is shown that, among companies with multiple large shareholders (45% of the whole sample), about 25% have the largest shareholder holding less than 50% of shares of the company so that there is no single shareholder with full control of the company, while 75% of such companies have shareholders with full control.

It is further shown that, while about 53% of the sampled firms with multiple large shareholders have their control shared between the first two larger shareholders, 46.5% of them are reported to have their control shared by more than two larger shareholders. These results provide the basis of our suggested argument that the presence of multiple large shareholders and sharing of control among different shareholders reduces the extent to which the largest block holders expropriate minority shareholders.

To examine the impact of multiple large shareholders on corporate leverage, the composition and size of a controlling group is assessed. The study reports a positive relationship between control contestability (measured as the relative size of the control-rights of the largest and second largest shareholder) and leverage, consistent with the hypothesis that debt facilitates efficient monitoring. The efficient monitoring of other larger shareholders prevents controlling shareholders from using related party transactions to exploit minority shareholders.

More specifically, to establish whether the identity of the largest and second largest shareholders matters in corporate financial decisions, a two samples mean comparison test is employed. The results show that companies where both of the first two largest shareholders are family firms use more debt in their capital structures than companies whose largest shareholder is a family and the second largest is a financial institution. This finding is consistent with the control incentives of family companies. In an attempt to retain the control, family companies use more debt in their capital structures so as to dilute the control of other shareholders. This action largely eliminates take-over possibilities.

With the assurance of control, family firms make some corporate decisions which are beneficial to family members and not to the company as a whole. The motivation behind such decisions is to pass ownership and control of the company to future generations. The presence of the stronger second-largest block holder from outside may make it difficult for

family companies to take decisions which fit in with their family succession plans. This may ultimately reduce the economic value of the firm.

The impact of the controlling group's composition on firm performance is examined and the results show that companies with only families in their controlling group perform worse than companies whose largest shareholder is a family and the second largest a widely-held financial institution. The results support the collusion effect view proposed by Maury and Pajuste (2005) that the marginal cost of extracting private benefits is higher where both the first and the second largest shareholders are families compared to a coalition group with the largest shareholder a family company and the second largest an institution. The lower the cost of extracting private benefits, the higher is the potential for expropriation which impacts negatively on the corporate value. This may be suggested as the possible reason why companies with only families in their controlling groups are associated with poor performance relative to those companies whose largest shareholder is a family and the second largest a widely-held financial institution.

Regardless of the age of the data set used in this study, the researcher is confident that the results presented in this study are still valid. This is because of the stable ownership structure of UK companies observed over time. This ownership stability is reported over period 1991-2001 by Marchica and Mura, (2005) ,over the period 1999-2005 by Florackis and Ozkan (2009) and over the period 2003-2007 by Kormie (2011). Therefore, following the reports of previous studies, UK ownership structure has been stable from 1991 to 2007. The researcher also collected some pilot ownership data prior to adapting Faccio and Lang (2002) raw ownership data for 6 years from 2004-2009 and found that ownership change very insignificantly with change of below 1% in most companies. It can therefore be confirmed that there is no observed significant change in ownership over time in UK companies and the

researcher is of the opinion that, if same tests were conducted using a recent data set the results will remain unchanged.

Finally, the study concludes that ownership affects performance directly and indirectly through dividend policy and debt policy. It is revealed that in practice, what affects firm performance is the quality of the firm's financial and dividend decisions. Good financial and dividend decisions result in better firm performance. Financial policies which are set for controlling shareholders' benefits are detrimental to firm performance. It is confirmed from this study that controlling shareholders extract private benefits by pursuing poor financial policies - such as using more debt in the firm's capital structure (which may result in bankruptcy) - so as to prevent dilution of their control or they may cut dividends and use the money for their private benefits. This ultimately depresses corporate value.

As reported in this study it is clearly observable that as the control rights of the largest shareholder increases relative to the cash flow rights, corporate dividend payout ratio decreases. This, as previously discussed, is due to less incentive controlling shareholders have to pay dividends because of their potential relatively smaller shares of dividends (cash flow rights) and higher incentive to divert the distributable income to projects which benefit them more than the corporation at large. This ultimately reduces the corporate value because such projects are either negative NPV projects or non-value maximizing. This is also consistent with results from performance-ownership and control relationship. It is reported that as the control rights of the controlling shareholder increases relative to cash flow rights the firm performance decreases. Therefore, as control rights of the controlling shareholder increases relative to cash flow rights, dividend payout ratio decreases resulting into corporate value reduction. This is consistent with dividend relevance theory which suggests that payment of dividends attracts the potential investors and is the signal of future success and

current liquidity of the company. Hence dividends cut may lead to decrease in company share price, hence corporate value reduction.

To prevent their control from dilution, colluding with managers, controlling shareholders usually prefer debt issuance than stock issuance because stock issuance may increase the ownership base, hence control dilution. This is supported by the results previously reported that as control rights of the controlling shareholder increases relative to cash flow rights, corporate debt ratio increases. This increase in debt ratio may harm the firm value because controlling shareholders, due to their power and ability to collude with managers, may choose projects with relatively more financial risks. Upon failure of the projects, which in the extreme case results into bankruptcy, the corporate value becomes at risk.

Hence, it can be confirmed that the increase in control rights of the controlling shareholder relative to the cash flow rights leads to increase in debt ratio which ultimately reduces firm performance.

8.2 Limitations of the Study and Recommendations for Further Researches

As with any other research study, this study has limitations of its own. The first limitation is the availability of ownership time series data. However, the author believes that the results are not affected in any way by this limitation due to the nature of the study. This is the concern of causality. Coles *et al.* (2006) doubted the ability of instrumental variables to identify the impact of ownership on performance. Their study did not take into account the presence of multiple large shareholders. However, the consideration of multiple block holders may make the matter even worse, as the identification would be more difficult due to ownership complexity. Even if this were the case, the essence of this thesis is not to demonstrate the impact of exogenous fluctuations of ownership on performance and financial

policies. Rather, the purpose of this thesis is to show that the relationship between ownership and control and performance and financial policies are in line with the theoretical models, which emphasize the unique corporate governance features of those firms with multiple large shareholders.

It has been consistently reported that the ownership structure in the UK is stable over time. It has been suggested in previous UK studies, such as Marchica and Mura, (2005) and most recently Florackis and Ozkan (2009), that the ownership structure is indeed stable over time. Both Marchica and Mura (2005) (using the sample of UK ownership data for period 1991-2001) and Florackis and Ozkan (2009) (covering the period of 1999-2005) reported on this stable ownership structure of UK companies. The most recent time series data used by Kormie (2011) takes the period 2003-2007 and still reports a stable ownership structure of UK companies. Therefore, following the reports of previous UK studies, ownership structure has been stable from 1991 to 2007. Hence the non-availability of time series data should not be seen as a potential threat to the validity of the results presented in this study.

Second, given the absence of time-series ownership data, this study was unable to use fixed-effects or dynamic panel procedures to eliminate concerns about potential unobserved heterogeneity. However the study tried to reduce this effect by including a wide array of firm specific factors as in Laeven and Levine (2008).

Third, constrained by data, our study is limited in its measurement of ownership structure. Future research, using a different measurement, would give a more robust result, for instance, ownership by corporate managers. This would also be a useful variable to test its impact on performance in an environment where ownership structure is concentrated, as in our case.

Fourth, being unable to collect data on corporate board structure, limits the thesis to examine the participation of controlling shareholders on board rooms. This would be necessary to see whether the more independent boards would offer a solution to the observed expropriation. Future studies may also examine whether corporate board structure can reduce the reported expropriation effects in this study.

Fifth, the significant relocation of UK equity ownership from institutions to foreign investors was reported in a recent report by Office for National Statistics (2010). This study suggests the potential for future research to assess the impact of this change on corporate strategies. It is reflected in literature that foreign owners, especially those from high quality corporate governance regimes such as the US, have a greater chance of reducing the reported expropriation in this study. For instance the presence of a foreign investor in a controlling group may make it harder for expropriation of minority shareholder to take place.

Sixth, this study was confined to UK companies only, which might limit its comparability with data from other countries. The comparative study, however, is not undertaken due to the internal breadth of the study itself. An attempt to do so may require more time due to data collection hassles involved in a study of this type, which requires a manual collection of ownership data. It is suggested that further research be comprehensive and compares the results of different countries.

8.3 Policy Implication of the Study

The results of this study are important to authorities regulating trading rules in the LSE, to Government, and to family firms.

First of all, the stock exchange should be aware of the finding in this study that there seem to be loopholes from listing rules which might be used by controlling shareholders to accumulate more voting power to expropriate the interests of minority shareholders. The authorities have to revisit listing rules, and set a specific level of voting rights, or minimum vote ratio attached to preference shares, which is considered to be adequate, to reduce the possibility of controlling shareholders and managers, using their discretion on this issue. This is important because the majority of UK companies which separate control from ownership do this employing dual-class equity structures where two types of shares are issued, ordinary shares (with more voting rights) and preference shares (with lower voting rights). This study argues that, although listing rules require adequate voting rights to be attached to preference shares, so that lower deviation between control and ownership is maintained, the rules do not make clear *what adequate voting rights are*.

Second, regarding family firms, the study suggests that family firms should consider moving away from the tradition of inheriting managerial positions. It is suggested that, when the CEO position is left vacant by the founder, the proper substitute should be identified from within or outside the company, primarily based on the competency of the selected individual to move the company to a higher level, instead of just appointing a family member to take the position even if he/she lacks the requisite management skills.

The study is aware that family firms usually appoint individuals from within the family to take over managerial positions so as to retain a family culture and control. Taking this into account, and without affecting those perfectly valid family values which are core to their

performance, the study suggests family companies should plan in advance the succession arrangements by educating some family members for managerial positions so that when the founder steps down there is a competent member of the family to take over.

If the problem of managerial professionalism in family firms is solved then family firms are expected to perform better. In this regard, Government and regulators should lay the necessary foundations to facilitate the development of these companies because due to their peculiarities and their number (30% of the sample of firms) they can play a vital and active role in promoting economic growth.

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