Institutional ownership and firm short termism: new insights on European companies

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The Nature and Governance of the Corporation
Drivers of Change in Corporate Governance

Outline

1. Motivation
2. Literature
3. Some descriptive statistics about the evolution of ownership structure in Europe since 1999
4. Hypothesis, method & preliminary results
5. Conclusion and perspective

1. MOTIVATION

Motivation: institutional investors & financialisation of corporate governance

- Since the late nineties, US institutional investors have diversified their portfolio by buying shares of French corporations but also of other continental European companies (Morin, 2000).
- At the same moment, there is an increasing concern in the literature about financialisation of corporate governance and firm strategies (Lazonick and Sullivan, 2000; Aglietta, 2000), that is to say the ascendancy of ‘shareholder value’ as the primary goal of firms at the expense of long term investment.
- An empirical finding within the financialisation literature is that the distribution of cash to shareholders, and/or the investment in financial assets, have been negatively associated with capital investment or R&D, at the macro level (Crotty 2003, Krippner 2005, Orhangazi 2008, Hecht 2014) or at the firm level (e.g. Orhangazi 2008, Hecht 2014).
- Nevertheless, until recently, only few empirical studies confirmed the link between institutional ownership and short-termism in firms’ strategies.
Motivation: institutional investors & short-termism

- Short termism means that some shareholders prefer to obtain a very short term profit, thanks to dividend, share buyback and capital gain at the expense of the long term value of the firm.
- Moreover, hostile takeovers & stock options are strong incentives for managers to pursue these payout policies.
- Short termism is today a concern for international organizations:
  - OECD project on *Institutional investors and long-term investment*, launched in 2012 (e.g. Çelik and Isaksson, 2014, Institutional Investors as Owners: Who are they and what do they do?).

Concerns about short-termism are not new

- First debates about short-termism during the eighties:
  - Corporate raiders and activism from public pension funds in the US.
- New debates during the 2000’s:
  - In the US: new activism from Hedge funds (Starks and Gillan, 2007).
  - In Europe: new US institutional investors in ownership structures of continental European corporations and new activism from hedge funds (financialisation, Van der Zwan, 2014).

2. LITERATURE

Motivation: even financial investors are agree with the negative effect of IO

Larry Fink; BlackRock’s CEO
The World’s Largest Asset Manager

March, 2014, Larry Fink send a letter to CEOs of every S&P 500 companies to warning them about quick dividends and share buybacks in response to the “the short-term demands of the capital markets”. WSJ

“Returning cash to shareholders should be part of a balanced capital strategy; however, when done for the wrong reasons and at the expense of capital investment, it can jeopardize a company’s ability to generate sustainable long-term returns.”

A short term performance is necessary, but companies have to “simultaneously make those investments – in innovation and product enhancements, capital and plant equipment, employee development (...) – that will sustain growth.”

In this paper we want to study the long term investment in employee development and in real investment.
Managers & short-termism: the mainstream view

- Imperfection of capital markets (informational asymmetries).
- Shareholders assess the value of the firm thanks to short-term signals send by managers: short-term profits, dividends or share buybacks.
- Managerial decisions (investments) are then distorted by these communication which and investment is lower than it would be in perfect market.
- This biased behaviour is called *managerial myopia* and is due to:
  - Career concern and compensation of managers (Holmström 1982; Narayanan 1985)
  - Dividend policy (Miller and Rock, 1985)
  - Takeover threats (Stein, 1988, 1989; Shleifer and Vishny 1990)
- ECMH: myopia does not come from markets because they are efficient (Jensen, 1988):
  - Short-term reactions by shareholders are a disciplinary device.
  - Shareholders rationally expect managerial myopia and discount share price, which effectively depress investment.
- In order to reduce short-termism, it is necessary to reduce asymmetries of information: more transparency and improving monitoring by shareholders or financial intermediaries (Edmans, 2009; Von Thadden, 1995).

Shareholders & short-termism: a (post-)keynesian perspective

- Capital markets are short-termist: they are built to provide liquidity for financial investors.
- Keynes (1936): “But the Stock Exchange revalues many investments every day and the revaluations give a frequent opportunity to the individual (though not to the community as a whole) to revise his commitments. It is as though a farmer, having tapped his barometer after breakfast, could decide to remove his capital from the farming business between 10 and 11 in the morning and reconsider whether he should return to it later in the week. But the daily revaluations of the Stock Exchange, though they are primarily made to facilitate transfers of old investments between one individual and another, inevitably exert a decisive influence on the rate of current investment.”
- Potential benefits: new investors convey cash to firms because they believe that they can leave the corporation at any time.
- Potential cost:
  - Markets do not assess the fundamental value of the firm. They rely on a convention in a self-reinforcing process which is disturbing for capital expenditures by firms.
  - Buying and selling shares will determine the price and the ability to fund new or existing corporations (IPO or seasoned equity issuance during bubbles but preference for buying existing shares if prices are lower or if they do not follow a growing convention).

First empirical studies with contrasting results during the 1980’s

- During the 1980’s:
  - Jarrell and Lehn (1985): IO → higher R&D expenses
  - Meulbroek et al. (1990): anti-takeover devices → lower R&D expenses.
  - Samuel (2000): IO → higher capex but lower R&D expenses.
  - David et al. (2001): no effect of IO on R&D expenses.
  - Kochhar et David (1996): no effect of IO on product innovation:
    - Negative effect when IO are banks, insurance companies, private pension funds.
    - Positive effect when IO are mutual funds, public pension funds or endowment funds.

Contrasting results during the 1990s but with some strong evidence for short-termism

- During the 1980’s & the 1990’s:
  - Bushee (1998, 2001): two kinds of IO:
    - Transient or impatient IO (high turnover, high diversification): corporations cut their R&D expenditures when benefits decline; short-term benefits highly increase stock prices.
    - Other IO: corporations do not cut their R&D expenses when benefits decline
  - Matsumato (2002): corporations with higher IO have the highest probability to reach or beat analyst consensus thanks to accounting manipulation.
  - Wahal et McConnell (2000): IO with high turnover → higher R&D expenses and higher capex.
  - Aghion et al. (2013): IO slightly improves R&D expenditures but IO (and impatient IO) improves R&D productivity (number of patent citations/R&D expenses).
A convergence of results for the 2000’s

- During the 2000’s:
  - Hedge funds:
    - Coffee et Palia (2014): hedge funds activism → transfer of wealth from employees and creditors to shareholders.
    - Brav et al. (2014): hedge funds activism → higher R&D productivity.
  - Stock exchange or/and Institutional investors:
    - Brossard et al. (2013), ICC: on a sample of innovative European companies: positive effect of IO but negative effect of impatient IO (portfolio turnover < 24 months) on R&D expenditures.
    - Asker et al. (2015), RFS: US: non-listed corporations invest more than listed corporations! Among listed corporations, the ones with higher transient IO have lower capex expenditures.
  - Liquidity:
    - Fang et al. (2014), JoF: higher liquidity → lower innovation, because of transient IO or takeover threats.

- Our study extends recent results of Brossard et al. (2013) to a larger sample of European companies and on the long term investment in real assets and in employment.

3. SOME DESCRIPTIVE STATISTICS ON THE EVOLUTION OF OWNERSHIP STRUCTURE IN EUROPE SINCE 1999

The data sets

A representative sample of the non financial European companies listed on a stock market (the largest European stock market index: the DJ Eurostoxx600)

A sample of the 20 biggest non financial European companies (main stock index of 12 countries)

1999-2012
905 corporations
9506 observations
(8805 with accounting data)

2001-2012
339 corporations
3333 observations

- Composition of the index, market and accounting data come from Thomson Financial.
- Ownership data comes from Thomson One Banker Ownership (TOBO) (ex CDA/Spectrum).
- Descriptive statistics on ownership are for the non financial corporations of the Eurostoxx600

The Data

<table>
<thead>
<tr>
<th>Rank by mean market cap (1999-2012) in USD</th>
<th>Rank by number of non financial firm in the country Eurostoxx 600 (1999-2012)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 United Kingdom  2,77191E+12</td>
<td>United Kingdom  287</td>
</tr>
<tr>
<td>2 France  1,64743E+12</td>
<td>France  112</td>
</tr>
<tr>
<td>3 Germany  1,28689E+12</td>
<td>Germany  81</td>
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<tr>
<td>4 Switzerland  9,0036E+11</td>
<td>Switzerland  62</td>
</tr>
<tr>
<td>5 Spain  8,97493E+11</td>
<td>Netherlands  51</td>
</tr>
<tr>
<td>6 Italy  6,29635E+11</td>
<td>Spain  48</td>
</tr>
<tr>
<td>7 Netherlands  5,99483E+11</td>
<td>Italy  47</td>
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<tr>
<td>8 Sweden  3,96612E+11</td>
<td>Sweden  43</td>
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<td>9 Belgium  2,43503E+11</td>
<td>Finland  26</td>
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<td>10 Finland  1,99358E+11</td>
<td>Denmark  22</td>
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<tr>
<td>11 Norway  1,63591E+11</td>
<td>Greece  22</td>
</tr>
<tr>
<td>12 Denmark  1,59418E+11</td>
<td>Belgium  20</td>
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<tr>
<td>13 Greece  1,13109E+11</td>
<td>Norway  19</td>
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<td>15 Austria  8141831275</td>
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<td>16 Portugal  72523318350</td>
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### The Data

<table>
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<th>Year</th>
<th>N of firms</th>
<th>Number of observations</th>
<th>Nb of year in the sample</th>
<th>Percent</th>
<th>Cum.</th>
<th>Percent</th>
<th>Cum.</th>
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<td>3.69</td>
<td>65.29</td>
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<td>7.10</td>
<td>2.31</td>
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<td>2009</td>
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<td>319</td>
<td>6.99</td>
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<td>661</td>
<td>12</td>
<td>372</td>
<td>6.95</td>
<td>3.91</td>
<td>86.32</td>
<td>26.44</td>
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<td>2011</td>
<td>657</td>
<td>13</td>
<td>819</td>
<td>6.91</td>
<td>8.62</td>
<td>93.24</td>
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<td>2012</td>
<td>643</td>
<td>14</td>
<td>6,174</td>
<td>6.76</td>
<td>64.95</td>
<td>100.00</td>
<td>100.00</td>
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**Total** 9,506 100.00 **Total** 9,506 100.00

### Ownership concentration in Europe:

<table>
<thead>
<tr>
<th>Country</th>
<th>N</th>
<th>mean</th>
<th>sd</th>
<th>min</th>
<th>max</th>
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<td>United Kingdom</td>
<td>2835</td>
<td>13.04</td>
<td>11.14</td>
<td>0.01</td>
<td>77.53</td>
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<tr>
<td>Sweden</td>
<td>492</td>
<td>15.90</td>
<td>13.60</td>
<td>0.02</td>
<td>76.56</td>
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<tr>
<td>Netherlands</td>
<td>492</td>
<td>16.66</td>
<td>17.21</td>
<td>0.24</td>
<td>80.29</td>
</tr>
<tr>
<td>Finland</td>
<td>310</td>
<td>17.65</td>
<td>16.13</td>
<td>0.78</td>
<td>81.22</td>
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<td>Ireland</td>
<td>170</td>
<td>18.19</td>
<td>16.13</td>
<td>0.12</td>
<td>72.45</td>
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<tr>
<td>Switzerland</td>
<td>728</td>
<td>21.17</td>
<td>19.53</td>
<td>0.01</td>
<td>99.31</td>
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<tr>
<td>Greece</td>
<td>250</td>
<td>24.35</td>
<td>24.24</td>
<td>0.01</td>
<td>90.12</td>
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<tr>
<td>Norway</td>
<td>223</td>
<td>24.90</td>
<td>19.46</td>
<td>0.45</td>
<td>85.40</td>
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<tr>
<td>Denmark</td>
<td>249</td>
<td>26.40</td>
<td>20.78</td>
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<td>88.20</td>
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<td>Germany</td>
<td>901</td>
<td>26.71</td>
<td>22.24</td>
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<td>1173</td>
<td>29.02</td>
<td>23.10</td>
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<td>Spain</td>
<td>486</td>
<td>29.39</td>
<td>22.07</td>
<td>0.55</td>
<td>97.18</td>
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<td>Austria</td>
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<td>4.67</td>
<td>51.00</td>
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<td>Belgium</td>
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<td>21.38</td>
<td>0.80</td>
<td>95.51</td>
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<td>Portugal</td>
<td>100</td>
<td>34.20</td>
<td>20.37</td>
<td>3.82</td>
<td>94.11</td>
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<tr>
<td>Italy</td>
<td>468</td>
<td>43.67</td>
<td>20.18</td>
<td>0.06</td>
<td>94.83</td>
</tr>
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</table>

**Total** 9,212 21.84 **Total** 9,506 100.00

### Ownership concentration in Europe:

**The 1st shareholder**
- Continental (red) vs. UK (blue)

**From the 2nd to the 10th shareholder**
- Continental (red) vs. UK (blue)

**Significant Correlation coefficient market cap & pct o/s 1st:**
- TOTAL: -0.0528, obs=9212
- AS: -0.1186, obs=2835
- CONTINENTAL: -0.0460, obs=6377
Following Brossard, Lavigne and Sakınç (2013), we compute 3 kinds of information on ownership:

- Share held by anglo-saxon shareholders
- Share held by strategic entities vs. Institutional owners
- Share held by impatient institutional owners (with a portfolio turnover < 24 months).

The aim of these indicators is to identify corporations with an important amount of capital that can be withdrawn instantaneously. It is a sign of a lack of commitment of capital and it could depress investments in real assets or in employment.
### Number of Shareholders by Type

<table>
<thead>
<tr>
<th>Rank of Shareholder</th>
<th>IM</th>
<th>SE</th>
<th>Impatient</th>
<th>Patient</th>
<th>SE and Impatient</th>
<th>IM and Impatient</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>49.00</td>
<td>51.00</td>
<td>8.32</td>
<td>91.68</td>
<td>0.00</td>
<td>100.00</td>
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<tr>
<td>5</td>
<td>90.00</td>
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<td>17.46</td>
<td>82.54</td>
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<td>10</td>
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<td>15</td>
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<td>20</td>
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<td>3.41</td>
<td>28.36</td>
<td>71.64</td>
<td>0.00</td>
<td>100.00</td>
</tr>
</tbody>
</table>

In 1999, 91% of UK corporations and 50% of continental corporations are mainly held by impatient institutional investors.

In 1999, 1.6% of UK corporations and 5.6% of continental corporations are mainly held by impatient institutional investors.

In 1999, a third of the explained ownership held by impatient institutional investors: continental (red) vs. UK (blue)

In 1999, a third of the explained ownership held by impatient institutional investors: continental (red) vs. UK (blue)
4. HYPOTHESIS, METHOD & PRELIMINARY RESULTS

Three main references


Method: financialisation and investment following Hecht (2014)

\[
I/K = \\
1 \text{ year lag investment} / K \\
1 \text{ year lag operating income (profit)} / K \\
1 \text{ year lag internal finance (stock)} / K \\
1 \text{ year lag net stock issue} / K \\
1 \text{ year lag long term debt} / K \\
1 \text{ year lag financial profit} / K \\
1 \text{ year lag interest} / K \\
1 \text{ year lag } K / L
\]

\[
\text{Risk: tobin } q
\]

Year

- Log-log specification
- Firm fixed effects (country & sector)
- \( \text{Owner}_{t-1} \) is dummy indicating if the share held by a kind of shareholder is superior to the half of ownership held by the first 20 shareholders:
  - \( \text{dui} \) = shares owned by institutional investor
  - \( \text{duanglo} \) = shares owned by Anglo-Saxon investor
  - \( \text{duimp} \) = shares owned by impatient shareholders

<table>
<thead>
<tr>
<th>Variables</th>
<th>Definitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>firm’s annual capital expenditures</td>
</tr>
<tr>
<td>K</td>
<td>firm’s capital stock: net plant, property and equipment</td>
</tr>
<tr>
<td>S</td>
<td>firm’s annual total sales</td>
</tr>
<tr>
<td>π</td>
<td>operating income net of depreciation</td>
</tr>
<tr>
<td>INTERNF</td>
<td>Internal finance: firm’s balance sheet value of cash and short-term securities</td>
</tr>
<tr>
<td>NETSTKisu</td>
<td>Net stock issuance: difference between the sale and purchase of common and preferred stock in a given year per a firm’s statement of cash flows</td>
</tr>
<tr>
<td>LTDEBT</td>
<td>contemporaneous value of total long-term debt or Net debt issuance</td>
</tr>
<tr>
<td>πf</td>
<td>Financial profits: interest income plus equity in net earnings (i.e. earnings of a subsidiary not consolidated within the parent company)</td>
</tr>
<tr>
<td>INTEREST</td>
<td>total interest paid to bondholders and other creditors</td>
</tr>
<tr>
<td>CASHDIV</td>
<td>cash dividends</td>
</tr>
<tr>
<td>L</td>
<td>number of employees</td>
</tr>
<tr>
<td>TOBIN</td>
<td>firm’s ratio of market to book value</td>
</tr>
<tr>
<td>DU_IMP20</td>
<td>dummy indicating if the share held by impatient shareholders is superior to the total owned by the first 20 shareholders</td>
</tr>
</tbody>
</table>
Method: the elasticity of employment level to variation of the economic activity

\[ \Delta N_{i,t} = \alpha_1 Y_{i,t-1} + \alpha_2 Owner_{i,t-1} + \alpha_3 Shock_{i,t} + \alpha_4 (Owner_{i,t-1} \times Shock_{i,t}) + \delta_i + \theta_t + \varepsilon_{i,t} \]

- \( \Delta N_{i,t} \) = employment level variation of firm \( i \) between \( t \) and \( t-1 \)
- \( Owner_{i,t-1} \) = dummy indicating if the share held by a kind of shareholder is to the half of ownership held by the first 10 or 20 shareholders:
  - \( duii = \) shares owned by institutional investor
  - \( duango = \) shares owned by Anglo-Saxon investor
  - \( duimp = \) shares owned by impatient shareholders
- \( Shock_{i,t} \) = shock on the sales (multiplying factor of sales between \( t \) and \( t-1 \) = Sales_t/Sales_{t-1})
- \( Owner_{i,t-1} \times Shock_{i,t} \) = the shock for the category
- \( Y_{i,t-1} \) = lagged firm control variables:
  - \( \theta_t \) = time fixed effects
- \( \delta_i \) = country & sector fixed effects or firm fixed effects
- \( \varepsilon_{i,t} \) = random shock

Conclusion and Perspective

- For investment:
  - No effect of institutional investors per se.
  - Strong negative relationship between investments & impatient institutional investors (or UK/US investors).
- For employment:
  - No effect of impatient investors with high portfolio turnover.
  - But a strong relationship between institutional investors, and the sensitivity of employment level to external shocks.
- Another typology of ownership, with a hand-coding of institutional investors.
- More robustness tests.
- Reach or beat analyst consensus in European corporations.