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Corporate Governance and Ownership Structure in Emerging
Markets: Evidence from Latin America

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ABSTRACT

In this research I study the role of ownership structures as a corporate governance mechanism in emerging economies. The highly concentrated ownership predominant in the Latin-American markets provides a rich environment to explore corporate governance practices in a regional setting. Corporate governance mechanisms affect firm value, market liquidity and the organization of industries and markets in a context of weak shareholder protection. Specifically, I examine performance effects that may be attributable to deviations between voting rights and cash-flow rights. I look at the extent to which controlling shareholders divert resources for their own consumption, in turn reducing shareholder value. Given the potential large private benefits of control, I also explore the motivation for outside investors to participate in the financing of the firm's activities. The results of the investigation will shed light on the question of how much (private consumption) is too much. Furthermore, I extend the literature on the interactions between several governance mechanisms and firm value.

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Executive summary.

I study the role of ownership structure as a corporate governance mechanism in emerging economies. Corporate governance mechanisms affect firm value, market liquidity and the organization of industries and markets in a context of weak shareholder protection. The ownership structure predominant in the Latin-American markets provides a rich environment to explore corporate governance practices in a regional setting.

One of the focal points of the corporate governance literature is the role of the ownership structure as a governance mechanism. According to one of the traditional finance paradigms, the ownership of public corporations is widely dispersed among atomistic investors. This paradigm is not applicable in many countries, particularly those in which a family, a business group or a government controls most of the publicly traded firms (Faccio and Lang, 2002, Claessens et. al., 2002 and Lins, 2003). Even in the US, controlling shareholders govern a large number of firms. A concentrated ownership structure gives rise to a new form of conflict of interest: between controlling shareholders and minority shareholders. The conflict of interest is characterized as the potential for asset diversion from the firms to the controlling shareholders, reducing overall shareholders' value.

In some cases, the existence of other blockholders, such as pension funds, would inhibit excessive private consumption by controlling shareholders. Usually, lenders would also have a similar monitoring role. However, to the extent that the firms' leverage is small, and blockholders collude with controlling shareholders, the monitoring incentives would vanish. Therefore, blockholders have the potential to negotiate with the controlling shareholder, either to obtain a share of the private benefits of control or to deter asset diversion. Which behaviour would the investor adopt depends on the identity of the investor, his/her stake in the firm, and the value of the stake with respect to the total value of his/her portfolio. Nevertheless, when the voting rights of controlling shareholders exceed the cash-flow rights, the incentives for asset diversion are magnified. The gap between voting rights and cash-flow rights is created and amplified by at least three mechanisms: aggregation of voting rights through business groups, use of multiple class shares, and indirect ownership through pyramidal structures. On the other hand, the temptation for asset diversion may be curtailed when external financial markets are incipient, inexistent, or too expensive and the investment requirements of growing business opportunities exceed internally generated funds, leaving equity as the only source of founding.

There are a number of published academic works that study corporate governance mechanisms in individual countries (Canada: Switzer and Kelly, 2006) as well as multi-country or regional studies (East Asia: Claessens et. al., 2002; Western Europe: Faccio and Lang, 2002; Cross-country: Lins, 2003). Some studies focus on developed countries while others focus on emerging or transition economies. However, to the best of my knowledge this is the first investigation that focuses on the Latin American market from a corporate governance perspective.

Research methodology.

The first part of this research project aims to characterize the ownership structure in Latin-American markets. My preliminary examination of a sample of publicly traded firms indicates that the top owner in these firms has between 4.99% and 100% of the voting shares, with an average holding of 53%. With such concentration of voting shares a shareholder is likely to gain a seat on the board, be motivated enough to monitor the management, file a law suit and/or obtain other benefits; and a conflict of interest between the majority shareholders and the minority shareholders is more likely to occur than a conflict of interest between management and shareholders (Bennedsen and Wolfenzon, 2000 and Claessens et. al., 2002). Therefore, I assume that the management behaves in the interest of the dominant shareholder. Bennedsen and Wolfenzon (2000) find that the optimal ownership structure will have a single large shareholder or a few large shareholders of similar size. In addition, several firms dominated by members of a business group may benefit from intra-firm financial transfers that are not necessarily market based, as in Claessens et. al. (2002). To examine the argument of conflict of interest between shareholders, I propose a new approach for the development of effective measures of share ownership. First, I identify each relevant shareholder. Next, each shareholder is assigned to a business group. Finally, I perform separate aggregations of voting rights and cash-flow rights within business groups. In addition, tools borrowed from graph theory are used to present comprehensive and detailed characteristics of ownership structures. I study the discrepancy between voting rights and cash-flow rights for the larger aggregated shareholders, as well as for characterized aggregated shareholders, as determinant of firm value. Since I use ownership data from year 2000 to 2006, panel data analysis techniques provide means to characterize unobserved heterogeneity for individual firms, as well as industry and country effects.

In the second part of the study, I explore the relations between several governance mechanisms and firm value. Governance mechanisms such as takeover activity are externally determined. Internally chosen mechanisms, such as the ownership of controlling shareholders are chosen to offset environmental mechanisms (Switzer and Kelly, 2006). Some mechanisms may not look individually optimal but they would be collectively optimal. For example, the cost of changing the controlling shareholder's ownership may exceed the benefits; it may be an optimal mechanism to maintain control of the firm. Therefore other governance mechanisms adjust to and maximize firm value. In addition, firm value and ownership may be endogenously determined (Lins, 2003). Consequently, a simultaneous equations system approach is used to analyze the relationships between governance mechanisms and firm value. I expand on the simultaneous equations approach of Agrawal and Knoeber (1996). In regressions of firm value on ownership variables and firm characteristics such as size and leverage levels, I use proxy variables to control for takeover activity, board size, board independence, cross-listing, dual class-shares and dual role of the chairman. For example, firms may opt to issue ADR, which would force them to improve disclosure. Similarly, using debt-financing increases outside monitoring. Both mechanisms may be used by controlling shareholders to precommit not to expropriate minority shareholders. Another interesting aspect to explore in Latin American markets is whether some firm characteristics or

ownership structures attract larger number of blockholders. Nenova (2003) conjectures that large firms are subject to greater scrutiny, which would make it costlier for them to extract private benefits. Claessens et. al. (2002) suggest that larger and older firms have also better disclosure, are more diversified, their stocks are more liquid, and are followed by more analysts, but have fewer growth opportunities.

The third part of this project focuses on the effects of ownership structures on the liquidity of the stock market. The ultimate defense strategy of an expropriated investor is to exit the position, provided that a market deep enough exists. In principle, this should not be a problem for a stock in the local index. However, a run by blockholders may hurt minority shareholders more than the consumption of private benefits by controlling shareholders. Moreover, to the extent that blockholders such as local pension funds have few diversification opportunities and their funds increase overtime, they are themselves “locked” into their positions and they would prefer increasing their monitoring than exiting large positions that would risk triggering a domino effect and precipitating a market wide crisis.

The role of the blockholders raises several questions pertaining its identity, motivations and behavior. I extend the analysis on the interaction between controlling shareholder and other blockholders (McConnell and Servaes (1990), Bennedsen and Wolfenzon (2000) and Lins (2003)). The results of this research project shed light on the motivations of investors to take large positions in a firm where there is potential for asset diversion. If been part of the expropriating coalition protects blockholders, holdings of non-voting shares remains a contradiction, or a fact in an underfinanced market. In addition, if lower ownership concentration increases stock markets’ liquidity, facilitating takeovers, and promptly exit from compromised positions, blockholders are incurring in additional risk cost at holding undiversified portfolios. Therefore some mechanisms should be on place to warrantee an adequate return on investment, to increase shareholder’s protection and to reduce market undervaluation. La Porta, Lopez-De-Silanes and Shleifer (1999) analyze the problem of monitoring families. I extend that approach to analyze the party (or parties) whose role is to monitor controlling shareholders. I also explore whether belonging to a business group strengthens bargaining positions, and the predisposition to collude in asset expropriation.

Literature review

The theoretical model of Bennedsen and Wolfenzon (2000) for closely held corporations shows that the founder of the firm can use control dilution as a mechanism to reduce asset diversion, which would be harmful for him. In their model some shareholders are large enough not to surrender control to the manager, but none is large enough to obtain control by himself. Diverting assets from the firm requires the consent of a coalition of large blockholders, and the winning coalition minimizes its cash-flow rights.

La Porta, Lopez-De-Silanes and Shleifer (1999) find that families or the state typically controls most large corporations in 27 wealthy economies, in 1995. Additionally, the

power of the controlling shareholder exceeds his cash-flow rights, and dispersed ownership is more of an exception in countries with poor shareholder protection, which tend to have civil law tradition . They suggest that a mandatory rule of one-share-one-vote will have little impact as long as pyramids remain the principal vehicle to separate ownership and control.

McConnell and Servaes (1990) investigate the cross-sectional relationship between firm value and equity ownership for a sample of US firms for years 1976 and 1986. They find that firm value first increases with insider ownership (alignment effects), and then it declines (entrenchment effects). Their sample average of inside ownership is about 13.9% and 11.84% for each period, and the inflexion point is close to 37%. In addition, they find no support for the hypothesis that blockholders have an independent effect on corporate value, but can not reject the conjecture that large blockholders and insider ownership operate in conjunction. Their results, however, do suggest that institutional ownership reinforce the positive effects of insider ownership on corporate value (efficient monitoring hypothesis). They also outline the potential endogenous problem (managers and founders can be more inclined to retain a large fraction of successful firms/managers of successful firms are more likely to be rewarded with additional stocks).

Claessens et. al. (2002) find that firm value increases with the cash-flow ownership of the largest shareholder, consistent with a positive incentive effect, for their sample of 1301 publicly trade firms in eight East Asian economies in 1996. However, firm value falls when control rights exceeded cash-flow rights for the dominant shareholder (entrenchment effect). Finally, they find that the separation of ownership and control in general, and not any mechanism in particular (pyramidal structures, dual-class shares, cross-holdings) is responsible for value discount.

Faccio and Lang (2002) analyze the ultimate ownership and control of 5232 corporations in 13 Western European countries, from 1996 to 1999. They find that firms are typically widely-held (36.93%) or family controlled (44.29%) with financial and large firms more likely to be widely-held, while non-financial and small firms are more likely to be family-controlled. In some countries, widely-held financial institutions or the government may be important controlling shareholders, but widely-held corporations control few firms. Although dual class shares, multiple control chains, cross-holdings and pyramidal structures are used to enhance control of the largest shareholders; on average the discrepancies between ownership (38.48%) and control (34.64%) are significant just in few countries. Closely controlled firms often have a sole control shareholder at the 10% cutoff level (53.99%) .

In Lins (2003) management groups own on average 30% of firms and are the largest blockholders in 2/3 of their sample, while non-management blockholders own 20% of voting rights. He uses a cross-sectional sample of 1433 public firms from 18 emerging markets, for the year 1995, which predates my sample. For robustness test he uses a two simultaneous equations model to account for endogeneity between ownership and firm value (firm value is lower as a result of expected costly agency problems/if a manager expects lower cash-flow he would tend to increase the discrepancy between his voting

rights and his cash-flow rights). He finds support for the managerial entrenchment hypothesis and concludes that the costs of the private benefits of control are capitalized into share prices in emerging markets. Additionally, he finds evidence that large non-management blockholders can reduce the valuation discount associated with expected managerial agency problems acting as a partial substitute for missing institutional governance mechanisms. He also shows that firm value declines as the separation of management group control and cash-flow rights gets larger. Finally, he suggests that future research should study why Latin American firms use non-voting equity structures with such frequency.

Nenova (2003) analyses a sample of 661 dual-class firms in 18 countries for the year 1997, developing an approach where a shareholder competing for control is willing to pay minority vote-owners a price up to his expected value of private benefits of control. Therefore, vote value can be identified as a lower bound of control benefits. She finds that control-block votes are value at more than a quarter of company market capitalization in Brazil and Chile.

Lefort and Walker (1999) describe the ownership of non-financial Chilean conglomerates. They consolidate the balance sheet of firms in defined economic groups to analyze the level of firm assets that are financed by minority shareholders' equity and debt. They indicate that pyramids are often used to separate ownership and control, and that controllers of Chilean conglomerates hold more shares than necessary to maintain control, suggesting potential large private benefits of controlling the cash-flow from subsidiaries. In addition, they find that board members are exclusively appointed within firms associated to their economic groups, indicating that economic groups do not collaborate with each other. Finally, pension funds and cross-listed shares (ADR's) constitute significant equity minorities.

Valadares and Leal (2000) show a high degree of ownership concentration for Brazilian public firms. The biggest shareholders has, on average 41% of the equity capital, while the five biggest have 61% for their sample of 325 firms in 1996. In 62% of the companies, a single shareholder owns more than 50% of the voting shares. They outline that corporations are the main direct investors, while individuals are the more important indirect owners (through pyramiding or cross-holdings).

Database characteristics and aggregation procedure.

My analysis is based on a unique database that provides detailed ownership information for publicly traded firms from Brazil, Chile, Colombia, Peru and Venezuela. Most of these firms are part of their respective country exchange index and hence may have liquidity advantages, relative to non index firms. The ownership database Economatica is matched to Bloomberg. The research focuses on the period 2000-2006. Brazilian and Chilean firms are the largest, and also outnumber firms in other countries. In terms of total assets, the average (median) size of the firms in the sample is 3515 millions of \$US (846 millions of \$US).

From the ownership database I obtain the percentage of voting and non-voting shares and the name of each shareholder². I also obtain the percentage of voting and non-voting shares owned by unnamed atomistic shareholders (floating shares) as well as the total number of voting and non-voting shares of the firm. There are firms with just one class of shares (voting or non-voting shares) held by atomistic shareholders. To the extent that voting shares are used to obtain and maintain control, they may be not traded at all or traded in blocks. Even in the case of public firms without voting shares floating, blockholders should use the medium of the stock exchange to trade, or use other formal market mechanisms such as a tender offer, to transfer control. Including owners of voting and non-voting shares, the number of named identifiable shareholders ranges from eighteen different shareholders to a solitary shareholder (who is always a voting shareholder). A given shareholder may occupy the dominant voting position in one firm, and be a marginal voting shareholder or just a non-voting shareholder in another firm or year. Additionally, a voting shareholder can also be a non-voting shareholder for the same firm-year, narrowing the gap between voting rights and cash-flow rights.

One of the main contributions of this study is to establish the identity of the shareholders. This identification facilitates an analysis of voting behavior by shareholder business groups. A business group is an ad-hoc grouping where distinct shareholders have ties such that during the shareholder's general meeting (or their representatives during the board of director's meeting) they will vote in the same direction in all matters, including actions that could expropriate other shareholders non-members of the coalition. Members of the coalition benefit, or remain neutral, from expropriation actions in the short run but these coalitions have medium and long horizons. Members of a coalition have common family names, have similar firm names likely to be copyright, or have multi-firm relationships (meeting at many firms). The identification of business groups allows for the calculation of aggregated voting rights and cash-flow rights from the percentage of voting and non-voting shares. Cash-flow rights represent claims in potential dividends.

First, every named shareholder is identified as member of an inter-temporal, cross-firms, business group or as a stand-alone investor. Stand-alone investors are either individual investors classified as business groups with just one member or corporate investors no members of any business group. Grouping shareholder in business groups assures that all the siblings in a family (along with spouses, cousins, parents and children) vote together (Claessens et. al., 2000). For example in 2005, Lucila, Barbara, Jaime, Carolina, Eduardo, Marian, Salvador, Silvia and Patricia Gubbins G. own each one 7.99% of voting shares of Soc. Minera Corona. The Succession Reynaldo Gubbins Granger owns an additional 6.5%. With a cutoff level of 10% it would be a publicly held firm; however it is closely held at 78.41%. Similarly, the votes of all the shares owned by a mutual fund through different financial products or by a bank through different branches are cast on the same direction. Second, the voting rights of all members of a business group are aggregated.

² Lins (2003) finds that managers of Latin American firms frequently use shares with superior voting rights to increase the voting rights associated with their cash-flow rights. He reports a mean (median) of 45% (51%) of non-voting shares in the equity capital structure in Peru and Brazil. Nenova (2003) reports that dual-class shares are frequent in Brazil, but less so in Chile

Similarly, the cash-flow rights are aggregated, and a direct correspondence is established between the voting rights and cash-flow rights, for each shareholder. Third, the newly aggregated shareholders are reorganized according to the level of aggregated voting rights. Aggregating voting rights may consolidate the position of the dominant shareholders, but the previously dominant shareholder -in terms of voting shares- can also be overthrown by grouping siblings that become more powerful after aggregation, in term of voting rights. Finally, as treasury stocks are controlled by the management and therefore by the dominant shareholder, I assign any treasury stocks' voting rights and cash-flow rights to the new top shareholder of the firm.

The aggregation procedure designed with nested steps takes care of pyramidal structures³, and of diversion from the one-share-one-vote rule through the use of preferred stocks. Business group members' voting rights are effectively aggregated only if they meet on the same firm. Thus, "over grouping" would have not major effects; "under grouping" would likely occur, due to limitations in finding reasonable links between shareholders. Moreover, cash-flow rights of voting shareholders are diluted, with respect to the simple percentage of voting shares, as cash-flow rights of other non-voting shareholders are taking into account. As a consequence, failing to aggregate voting and non-voting shares across members of a business group would result in a narrower (wider) voting rights/cash-flow rights gap, if the unaccounted percentage of voting shares were larger (smaller) than the unaccounted percentage of non-voting shares.

Extending Faccio and Lang (2002), Claessens et. al. (2002) and Lins (2003) I classify the shareholders members of the business groups and the stand alone corporations, but not the individual investors into 5 categories. The purpose of the classification is to predict their behavior (the direction of their votes) in cases of imminent conflict of interest between majority and minority shareholders. The 5 excluding categories are: Families, Institutional Investors, Corporations, Government and Others. I calculate the discrepancy between shareholders voting rights and cash-flow rights for the larger three shareholders as well as for an aggregated investor for every category in each firm. Similarly, I calculate the ratio of voting rights to cash-flow rights as in Lins (2003). A less than absolutely powerful dominant shareholder may decide to collude with the second or the third larger shareholder, depending of their identities and discrepancy between voting right and cash-flow rights, to obtain, maintain or strengthen control of the firm, and/or expropriate other minority shareholders. The aggregation and identification procedures above described allow me produce sophisticate ownership variables such as TOP2_3: voting rights of the top 2 shareholder provided that it is not an institutional investor or government, or voting rights of the top 3 shareholder provided that it is not an institutional investor or government (if the top 2 shareholder is an institutional investor or government).

³ The aggregation procedure is integral, and is closer to the method of Lins (2003) than to Faccio and Lang's (2002) or Claessens et. al. (2000), that use the "weakest link along the control chain" as a measure voting rights, and the product as a measure of control rights. With the weakest link approach a portion of voting rights are left unexercised.

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