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Pyramidal structure, firm capital structure exploitation and ultimate owners' dominance

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ABSTRACT

In this paper we investigate how pyramid structure, separating cash flow rights and control rights, allows ultimate owners to control the company's resources for the creation of private benefits and to avoid punishment for such conduct. Empirical tests are conducted using three-stage least squares regression. The estimated results provide support for the hypotheses proposed that the separation of cash flow rights and control rights have led to the use of excess leverage among pyramidal companies to preserve ultimate owners' control. High levels of leverage, affect the firm's valuation negatively because of the potential for financial distress. Thus, our findings may provide one additional explanation for the severity of the decrease in corporate value among the pyramidal companies in Malaysia as pointed out in the studies of Claessens et al. (2002), Lins (2003), and Lemmon and Lins (2003). Secondly, the empirical evidence from this study provides insight into the forces that influence corporate valuation of firms in developed countries particularly those that have pyramidal structure.

1. Introduction

By definition, a pyramid structure is a business entity, i.e., a group of companies, whose ownership structure displays a top–down chain of control. In such a structure, the ultimate owners are located at the apex of the pyramid structure with successive layers of firms below the ultimate owners. La Porta, Lopez-de-Silanes and Shleifer (1999) document that ultimate owners (UO) around the world usually use this pyramid structure to control several firms simultaneously.

A direct result of the pyramid structure is a separation of actual ownership or cash flow rights (CFR) and control rights (CR) in firms located in the lower part of the pyramid structure, Claessens, Djankov and Lang (2000). Accordingly, the separation of CFR and CR occurs because the pyramid structure enables the UO to establish control disproportionately to the amount of ownership the owners have in each of the successive firms. Consequently with such a pyramid structure, the UO's actual ownership position needed for control becomes smaller at each succeeding tier of the pyramid structure. Claessens, Djankov, Fan and Lang (2002) and Lemmon and Lins (2003) empirically show that the separation of CFR and CR of the UO devalued the interest of other shareholders in companies in which the divergence of CFR and CR exists. Both studies conclude that the interest of other shareholders was adversely affected whenever CFR and CR divergence exists because such divergence enables UOs to exploit their CR over the company's resources without being penalized for misconduct.

This study investigates the impact of the separation of CFR and CR resulting from the pyramidal structure on a firm's capital structure policy in a sample of Malaysian firms. In particular, the objective of this research is to determine whether the separation of CFR and CR adversely affects financing decisions, *i.e.*, capital structure, among exchange listed Malaysian firms with pyramid structure. The motivation for this study comes from the findings of Claessens et al. (2000) and Claessens et al. (2002). These two papers analyze a sample from East Asian firms and find that many of the East Asian firms, including Malaysian firms display a high degree of CFR and CR separation in the hands of the UOs as a result of the pyramid structure. Consequently, this separation of CFR and CR exerts a negative impact on Asian firms' corporate valuation. Claessens et al. (2000) on the other hand show that the level of control that the Asian pyramidal firms have over the Asian economies, in general, is significant. For instance, the East Asian pyramidal firms control 80% of the East Asian economies, as measured in terms of total corporate assets. For the Malaysian case in particular, pyramidal firms control 28% of the value of listed corporate assets. This observation suggests that a relatively small number of UOs of the pyramidal firms exert effective control in most of the East Asian economies, including the economy of Malaysia. The findings of Corsetti, Pesenti and Roubini (1998) and Driffield,

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Mahambare and Pal (2001) demonstrate that Asian firms, including Malaysian firms, have some problems with capital structures. Since capital structures are highly associated with corporate assets and because pyramidal-affiliated firms in Asia, including Malaysia, have significant control over total corporate assets, Claessens et al. (2000), supports the hypothesis used in this study to investigate if such capital structure mismanagement may be related to the presence of the pyramidal structure, in the case of firms listed on the Malaysian stock market.

The argument of Du and Dai (2004) provided some justification as to why a relationship could exist between the separation of CFR and CR (resulting from the pyramidal structure) and a firm's potential capital structure[1] problems. Based on this argument, the UO would have a tendency to raise the firm's leverage in firms located at the lower portions of the pyramid chain, to prevent the dilution of the shareholding dominance of the UO. The specific UO's motive of protecting dominance by capitalizing on the capital structure policy may sometimes cause firm leverage to be raised excessively. Consequently, the use of excessive leverage may put the firms into financial difficulty and possibly into bankruptcy.

In the event of bankruptcy, the impact of excessive leverage on other shareholders of the firm is adverse. However, because of the separation of CFR and CR that result from the pyramid structure, the impact of adverse outcomes on the UO's interests may be minimal. Du and Dai (2004) hypothesize that this asymmetrical situation of loss in bad states and gain in good states on the part of the UOs induces the UOs to engage in risk-taking behavior. As a result, the UOs are more likely to raise corporate leverage excessively to maintain the UOs dominance, without considering the financial distress that may be detrimental to other shareholders. The empirical results provide support for the hypotheses proposed. For instance, the results point out that the pyramid structure accommodates the entrenchment motive of the UO, which then leads to the *leverage increasing* effect. Ultimately, such excessive application of debt, because of its financial distress potential, affects a firm's valuation negatively.

This study contributes to the literature of pyramidal ownership in two ways. First, this research highlights the existence of a relatively risky financing policy among Malaysian pyramidal firms. Because financing policy has a significant impact on the firm's overall financial performance and valuation, Mahrt-Smith (2005), relatively risky financing policies may have led to the fragility of corporations which then translated into poor financial valuations. Thus, our empirical findings may provide one additional explanation for the severity of the decrease in corporate value among pyramidal companies in Malaysia as pointed out in Claessens et al. (2002), Lins et al. (2003), and Lemmon and Lins (2003). Secondly, empirical evidence from this study may provide insight into the forces that influence corporate valuation of firms in western countries particularly those that have pyramidal structure. For example, King and Santor (2008) examine how family ownership affects firm valuation in Canada. The authors find that a free standing family firm has a 17% higher valuation than family owned firms that are associated with pyramid structure. Finally, by using a three stage regression, we evaluate the possible relationship among the value of the firm, financing policy and pyramidal ownership structure at the same time addressing the issue of endogeneity among the three variables. In our opinion, such analysis is scarce in the literature, at least in the study of the Malaysian market. Therefore, we believe this study is a useful contribution to the literature.

The study is divided into six parts. First, the study provides the introduction and justification for the study of pyramid structure affiliated firms, research objectives, and possible contributions. The second and third parts of the study discuss the pyramid structure theory and capital structure theory, for the purpose of hypothesis generation. Specifically, part three, discusses the model development, estimation method, variable descriptions. Part four describes the data collection process. Part five discusses the empirical results from the regression estimations. Finally, part six summarizes the conclusions, implications and policy, limitations of the study, and suggestions for future research.

2. Pyramidal structure and the separation of cash flow rights (CFR) from control rights (CR)

In this section, we begin by explaining the nature of CFR, CR and the pyramid structure. Firms formed in a pyramid structure have a separation of CFR and CR, which could, in turn, lead to a reduction in the value of the firm (Claessens et al., 2002; Lemmon & Lins, 2003). The reduction in the value of the firm is the result of adverse financing decisions by the UOs whose decision creates an adverse capital.

CFRs represent owner's actual ownership in a company through share purchases (Claessens et al., 2000). Because ownership arises from investment, CFRs act as a proxy for owner investment in a company (Morck, Wolfenzon & Yeung, 2004). CRs represent voting rights for the UOs (Claessens et al., 2000). Logically, owners' control rights in a company should be represented by the owner's CFRs that arise from his actual investment. But because of the pyramid structure effect, CFR and Cr may not be equal.

Pyramid structure that creates the separation of CFR and CR is defined as owning a majority of the stock of one corporation that, in turn, holds a majority of the stock of another corporation (Heitor & Wolfenzon, 2006). For example, Halim bin Saad, a Malaysian entrepreneur, owns 28.3% of Renong Berhad (see Fig. 1). The 28.3% stake in Renong Berhad, makes Halim the effective majority stockholder and UO of Renong Berhad. Renong Berhad owns 32.5% of the shares of United Engineers Malaysia (UEM). The 32.5% ownership of UEM makes Renong the effective controlling shareholder of UEM. Halim controls Renong Berhad and Renong Berhad is a major shareholder of UEM, this gives Halim effective control of UEM.

In this pyramid group, Halim has a direct ownership of Renong only. For the rest of the firms in the pyramid structure, ownership comes

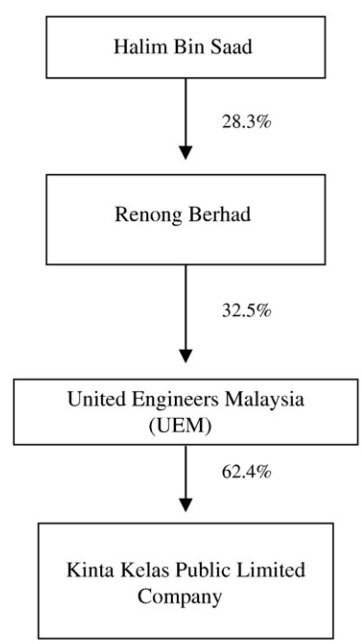

Fig. 1. Pyramidal structure.
Source: Lemmons and Lins (2003).

[1] Following Rajan and Zingales (1995) capital structure in this study refers to the proportion of debt being used. The word debt and leverage will be used interchangeably in this study.