



Large shareholders, monitoring, and ownership dynamics: Toward pure managerial firms?



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ABSTRACT

We study ownership dynamics when the manager and the large shareholder, both risk neutral, simultaneously choose effort and monitoring level respectively to serve their non-congruent interests. We show that there is a wedge between the valuation of shares by atomistic shareholders and the large shareholder's valuation. At the Markov-perfect equilibrium, the large shareholder divests her shares. If the incongruence of their interests is mild, divestment is drastic: all her shares are sold immediately. If their interests diverge sharply, the divestment is gradual in order to prevent a sharp fall in share price. In the limit the firm becomes purely managerial.

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1. Introduction

This paper develops a dynamic model of divestment by a large shareholder of a firm where her interest and that of the manager are not perfectly congruent. In our model, all shareholders, large and small, are risk neutral and have perfectly congruent objectives; however, only the large shareholder monitors the manager, while the small investors free ride on her monitoring effort.¹ We show how the degree of divergence of interests between the manager and the large shareholder affects the process of divestment. We demonstrate that when their interests diverge sharply, the divestment is gradual in order to prevent a sharp fall in share price. In the limit the firm becomes purely managerial, with a diverse ownership, and no monitoring by shareholders. This paper thus serves to highlight a mechanism that lies behind the tendency for corporate governance to move gradually from concentrated to dispersed ownership, a pattern that has been observed over more than a century in major capitalist economies (such as Great Britain and USA), and also more recently in countries such as Brazil. The key to our explanation is that the large shareholder cannot resist the temptation to sell shares when small investors' marginal benefit flow is greater than her own. While reducing her ownership (which entails a decrease in her monitoring effort) adversely affects the dividend flow to all investors, it does elicit more effort from the manager.

Berle and Means (1932) pointed to the transition to dispersed ownership in US. Recent empirical work confirms this tendency.² For UK, the same tendency was reported in Scott (1990), Franks et al. (2005), among others. Gorga (2009)

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¹ These assumptions are also made in the seminal contribution of Burkart et al. (1997), who however do not consider the dynamic process of divestment by the large shareholder. We build our dynamic model using the key elements of their static model.

² See, e.g., Demsetz and Lehn (1985), Mikkelson et al. (1997) and LaPorta et al. (1999).

documented a similar trend in Brazil from 1997 to 2002. Various reasons have been offered to explain the tendency for reduced concentration of ownership. Subrahmanyam and Titman (1999) argue that it becomes advantageous for firms to have a more dispersed ownership when informational asymmetries between insiders and external investors are less important. Roe (1996) and LaPorta et al. (1999) attribute the dispersion of ownership in US to the specific US laws and policies that discourage ownership concentration.

In this paper, we explain the tendency toward dispersed ownership by modelling, on the one hand, the trade-off between the gains from monitoring by a large shareholder and those from managerial initiatives, and on the other hand, the incentives for the large shareholder to divest (gradually, in typical cases) when her marginal valuation of ownership are below the small investors' valuation of the dividend stream that would arise on the assumption that she does not divest. The former aspect was investigated in an elegant static model by Burkart et al. (1997). The latter aspect is built on the literature concerning the Coase conjecture. Coase (1972) argued that when a monopolist producing a durable good at constant marginal cost cannot commit, rational expectations by potential buyers, and his ability to sell repeatedly would result in only one possible equilibrium outcome: he can only charge the price that would prevail under perfect competition, and the market demand is satisfied instantaneously.³ In our model, where the large shareholder corresponds to the Coasian monopolist, we show that Coase's conjecture holds if the divergence of interests between the large shareholder and the manager is mild; in contrast, if this divergence is very strong, the Coase conjecture fails, and the large shareholder will divest only gradually, with share price falling slowly over time, converging only in the long run to the competitive price. There is also an intermediate case, in which at first the large shareholder undertakes a massive sale of shares, to be followed by a slow process of divestment of the remaining shares.

The intuition behind our results is simple. In all cases, the divestment is caused by the fact that small shareholders perceive that, under the assumption that the large shareholder would not divest, their dividend stream per share is worth more than the large shareholder's marginal returns on a share (as she has to incur the monitoring cost). This wedge in marginal valuations implies that equilibrium must involve share trading. When the divergence of interests between the manager and the large shareholder is mild, her total instantaneous payoff (net of monitoring cost) is a strictly concave and increasing function of her fraction of ownership. Therefore, the revenue she would obtain from selling her shares at the competitive share price strictly dominates the present value of the stream of her instantaneous payoff obtained from maintaining her initial stock. Hence, her optimal policy is to sell off all her shares in one go. In the reverse case, the strong divergence of interests implies that her total instantaneous payoff is a strictly convex and increasing function of her fraction of ownership. The equilibrium share price function must in this case equal the large shareholder's capitalized marginal instantaneous payoff, which increases in her shareholding. Selling shares too quickly would cause a drastic fall in share price. So it is optimal for her to sell gradually.⁴

Our paper is related to a strand of the literature which deals with the dynamic process of adjustment of shareholding based on the insight into the literature on the Coase conjecture. Unlike our model specification which places emphasis on the conflict between the manager and the large shareholder, Gomes (2000) assumes that the large shareholder is also the manager of the firm. In that model, the owner–manager is playing a share-selling game against the collection of small investors. The gains from trade arise because by selling her shares, the owner–manager can diversify idiosyncratic risks with investors. The investors perceive that the owner–manager may be of one type or another. Although the owner–manager knows her type, investors know only the probability distribution of types. At each period, the owner–manager moves by choosing her new fraction of equity ownership and her effort level which is unobservable. Investors update their belief about the owner–manager's type, and they price shares in the market accordingly. Gomes shows that when outside investors face this adverse selection problem, the owner–manager's equilibrium strategy involves divesting her shares gradually over time (in contrast to the perfect information benchmark, where the owner–manager would sell all her shares in the first period). This gradualism is necessary for the entrepreneur to develop a reputation for treating minority shareholders well.

Gomes's conclusion that a risk-averse owner–manager would divest shares gradually over time is re-enforced by DeMarzo and Urošević (2006) who show (in a model with moral hazard instead of adverse selection) that if moral hazard is weak enough, the large shareholder trades immediately to the competitive price-taking allocation. With strong moral hazard, however, she will adjust her stake gradually. DeMarzo and Urošević (2006) emphasize the large shareholder's trade-off between risk diversification (which calls for a small shareholding) and her incentives and ability to improve the firm's performance (which increases with her fraction of ownership of her firm). DeMarzo and Urošević assume that the utility function of the large shareholder exhibits constant absolute risk aversion. Her wealth consists of a risk-free account and risky shares in her firm. Her sale strategy is motivated by consumption smoothing and risk diversification. When she sells her shares, investors anticipate a decrease in her effort. Hence, when reducing her stake, she is likely to generate a decrease in share price.⁵ Edelstein et al. (2010) generalize the model of DeMarzo and Urošević (2006) to a setting with

³ Coase's conjecture was confirmed by Stokey (1981), Gul et al. (1986), and others, under the assumptions that marginal cost is constant and the interval between successive sales shrinks to zero. Coase's conjecture fails if there is increasing marginal cost (Kahn, 1987), or depreciation (Karp, 1996).

⁴ In the intermediate case, which involves weak congruence of interests, coupled with a large stake, the large shareholder's instantaneous payoff function is S shaped: it is convex (concave) when her fraction of ownership is small (large). Then the large shareholder's optimal strategy is to make an initial lumpy sale of a fraction of her shares, to be followed by a time path of gradual sale of the remaining fraction.

⁵ The authors also noted that the time-inconsistency problem, raised by Coase, also applies to their model. They consider both the benchmark case where the large shareholder can commit ex ante to an ownership policy, and the case where commitment is not possible.

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