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Large controlling shareholders and stock price synchronicity ☆

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ABSTRACT

This paper examines the effect of controlling shareholders on stock price synchronicity by focusing on two salient corporate governance features in a concentrated ownership setting, namely, ultimate cash flow rights and the separation of voting and cash flow rights (i.e., excess control). Using a unique dataset of 654 French listed firms spanning 1998–2007, this study provides evidence that stock price synchronicity increases with excess control, supporting the argument that controlling shareholders tend to disclose less firm-specific information to conceal opportunistic practices. Additionally, this study shows that firms with substantial excess control are more likely to experience stock price crashes, consistent with the conjecture that controlling shareholders are more likely to hoard bad information when their control rights exceed their cash flow rights. Another important finding is that firms' stock prices are less synchronous and less likely to crash when controlling shareholders own a large fraction of cash flow rights. This is consistent with the argument that controlling shareholders have less incentive to adopt poor disclosure policies and to accumulate bad news, since high cash flow ownership aligns their interests with those of minority investors.

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1. Introduction

In his presidential address, Roll (1988) argues that the extent to which stock prices move together depends on the relative amounts of firm-specific and market-level information impounded into stock prices. The author finds that broad market and industry influences explain only a small portion of stock price movements.[1] Building on these findings, Morck et al. (2000) show that *R*-squared is lower in countries that properly protect investors' property rights.[2] They argue that better protection encourages informed trading, which facilitates the incorporation of firm-specific information into stock prices, leading to lower synchronicity. These seminal papers have motivated several follow-up studies that examine the association between stock price synchronicity and efficient capital allocation (Pindyck and Rotemberg, 1993; Wurgler, 2000), analyst activity (Piotroski and Roulstone, 2004; Chan and Hameed, 2006), earnings informativeness (Durnev et al., 2003), corporate transparency (Jin and Myers, 2006), voluntary disclosure (Haggard et al., 2008), earnings management (Hutton et al., 2009), audit quality (Gul et al., 2010), and the adoption of International Financial Reporting Standards (Kim and Shi, 2012).

However, a huge body of research documents that ownership structure affects the informational environment of a firm and its decision making. For instance, Ball et al. (2003) argue that, beyond accounting standards, the distribution of cash flow and voting rights shapes the outcome of financial reporting procedures. Other studies also show that ownership structure turns out to explain earnings management (Warfield et al., 1995), earnings informativeness (Fan and Wong, 2002), analyst following (Lang et al., 2004; Boubaker and Labégorre, 2008), accounting conservatism (Lafond and Roychowdhury, 2008), and the cost of corporate borrowing (Boubakri and Ghouma, 2010; Lin et al., 2011), among others.

This paper brings together these two strands of literature by addressing the important but hitherto underexplored question of whether ownership structure matters in explaining the synchronicity of stock price movements. In particular, it focuses on two important corporate governance characteristics in an environment where ownership is concentrated, namely, the ultimate cash flow

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[1] Roll (1988) documents that market-wide information explains, on average, 35% (20%) of a firm's monthly (daily) stock returns.

[2] The *R*-squared of Morck et al. (2000) is obtained from a modified market model regression.

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rights of controlling shareholders and the separation of voting and cash flow rights.[3] This study is also motivated by a growing literature providing evidence that corporate governance explains cross-sectional variations in stock returns (Gompers et al., 2003; Cremers and Nair, 2005; Bebchuk et al., 2009). More specifically, it follows in the footsteps of Gompers et al. (2010), who attempt to assess the direct linkage between ownership structure and stock returns in U.S. dual-class firms. This linkage is based on the idea that ownership structure affects managerial incentives and therefore exacerbates/mitigates agency problems between controlling and minority investors, which affects firms' information environment and stock returns.

Contrary to Berle and Means (1932), the corporate governance literature establishes that the presence of controlling shareholders is pervasive around the world (La Porta et al., 1999). Holderness et al. (1999) find that firms with dominant shareholders are widespread, even in the United States. Claessens et al. (2000) examine a sample of 2982 listed firms in nine East Asian countries. They find that roughly 67% of the sample firms are controlled by at least one large shareholder. Similarly, Faccio and Lang (2002) study the shareholdings of 5232 listed firms covering 13 Western European countries. They show that ownership structure is concentrated in around 63% of the firms.

These studies have cast doubt on the ownership structure of the modern corporation pictured by Berle and Means (1932) and have therefore shown that the relevant agency problem is not between shareholders and professional managers (Jensen and Meckling, 1976) but between large shareholders and minority investors, as advanced by Shleifer and Vishny (1997). Theoretical papers argue that ownership concentration helps mitigate agency conflicts between large and small shareholders inasmuch as higher ownership stakes increase the interest of large shareholders in a firm. As evidenced in previous empirical studies, concentrated ownership improves the informational environment of the firm (e.g., Warfield et al., 1995). Considering this line of inquiry, our study aims to examine the effect of ownership concentration on the information content of firms' stock prices and particularly stock price synchronicity.

However, due to the extensive use of control-enhancing mechanisms, including dual-class stocks and pyramid schemes, voting rights often exceed cash flow rights. Therefore, large shareholders are endowed with enhanced control compared to their interests in the firm, which may give rise to agency conflicts with minority investors that can take the form of private benefit consumption through tunneling (Bertrand et al., 2002), outright theft (Shleifer and Vishny, 1986; Johnson et al., 2000), inefficient empire building acquisitions (Masulis et al., 2009), the misuse of cash stockpiles (Attig et al., 2009), and higher employee remuneration (Cronqvist et al., 2009), among other things. Moreover, numerous studies provide evidence that the control–ownership wedge shapes the corporate information environment (Fan and Wong, 2002; Haw et al., 2004; Attig et al., 2006). However, the way it impinges on the information content of stock prices remains an intriguing and little explored question. Our study aims to fill this void.

Using a sample of 654 French listed firms from 1998 to 2007, we document a strong positive relationship between the control–ownership wedge and stock price synchronicity. This result supports our hypothesis that the separation of control and cash flow rights precludes information disclosure to the market. Conversely, we find that synchronicity decreases with the ultimate cash flow rights of the largest controlling shareholder, which is consistent with the argument that concentrated ownership facilitates the dissemination of firm-specific information. We conduct further analyses to examine the relation between ownership structure and crash risk. Our results show that firms with a larger control–ownership wedge (cash flow concentration) feature more (fewer) stock price crashes.

This paper contributes to the literature that studies the effect of ownership structure on stock price behavior in several ways. First, it empirically tests the effect of the separation of control and cash flow rights on stock price synchronicity. To the best of our knowledge, the current paper is the first to directly address this issue. Second, a large amount of research examines how stock price cash risk is influenced by the extent of voluntary disclosure (Haggard et al., 2008), financial statement transparency (Hutton et al., 2009), equity incentives (Kim et al., 2011a), corporate tax avoidance (Kim et al., 2011b), institutional investors (Callen and Fang, 2012), and management earnings guidance (Hamm et al., 2012), among other things. This paper provides new evidence to this fast-growing literature by examining how the control–ownership wedge and cash flow concentration affect stock price crash risk. Finally, unlike Brockman and Yan (2009), who conduct their study in the U.S. context, where ownership is widely dispersed and the relevant agency problem is between professional managers and all shareholders, and Gul et al. (2010), who focus on the Chinese context, where firms are typically state owned, we carry out our analysis in a concentrated ownership environment, namely, France, dominated by family firms and characterized by a substantial separation of control and cash flow rights maintained mainly through non-voting shares, double-voting shares, and pyramid schemes. This framework allows us to trace ownership structure back to the ultimate owner and, hence, to accurately assess the severity of agency problems between controlling and minority shareholders.

The remainder of the paper is structured as follows. Section 2 develops our hypotheses. Section 3 describes the data and presents the construction of the variables. Section 4 reports summary statistics and correlations between the variables. Section 5 discusses the empirical results. Section 6 conducts additional analyses. Section 7 performs various robustness checks and the final section concludes the paper.

2. Hypothesis development

This section develops our hypotheses on the effect of ownership structure on the extent to which stock prices impound industry- and market-wide information relative to firm-specific information in a concentrated ownership context. In particular, it focuses on how stock price synchronicity is affected by the separation of voting and cash flow rights and ownership concentration.

2.1. Excess control and stock price synchronicity

Grossman and Hart (1988) demonstrate that deviation from the one share–one vote rule maximizes the benefits of control for the controlling party relative to security holders and thus may not be socially optimal. Shleifer and Vishny (1997) argue that as ownership increases beyond a certain level, insiders gain almost full control of the firm and may prefer to extract private benefits of control that do not accrue to minority shareholders. This problem is more pronounced when control rights exceed cash flow claims (Claessens et al., 2002). Bebchuk (1999) demonstrates that when the private benefits of control are sizable, controlling shareholders strive to maintain a lock on the firm to maximize rent extraction.

Based on these arguments, we claim that a significant control–ownership wedge undermines the corporate informational environment. The underlying premise is that controlling shareholders, to hide any egregious opportunistic behavior, may opt for poor

[3] Since corporate control is measured based on voting rights, we use the terms *voting rights* and *control rights* interchangeably. We also use *excess control and control–ownership wedge* as substitutes.

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