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Form versus substance: The effect of ownership structure and corporate governance on firm value in Thailand

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A B S T R A C T

We examine the relation between the quality of corporate governance practices and firm value for Thai firms, which often have complex ownership structures. We develop a comprehensive measure of corporate governance and show that, in contrast to conventional measures of corporate governance, our measurement, on average, is positively associated with Tobin's *q*. Furthermore, we find that *q* values are lower for firms that exhibit deviations between cash flow rights and voting rights. We also find that the value benefits of complying with "good" corporate governance practices are nullified in the presence of pyramidal ownership structures, raising doubts on the effectiveness of governance measures when ownership structures are not transparent. We conclude that family control of firms through pyramidal ownership structures can allow firms to seemingly comply with preferred governance practices but also use the control to their advantage.

1. Introduction

In July 1997, the Bank of Thailand discontinued the fixed exchange rate regime which had been in place for decades. Thailand, an emerging nation, with a promising economic future, tumbled into the worst financial crisis in its history. In the process, Thailand also dragged many neighboring economies along with it into a region-wide economic downturn, the likes of which no country in the region had ever experienced before. Following this crisis, and its resolution, corporate governance has received considerable attention from regulators and practitioners in all the Asia–Pacific countries. The main impetus for this heightened attention stems from evidence emerging from the financial crisis that the aggressive financing practices and poor investment decisions, associated with the financial downturn, were a result of poor corporate governance practices among large public corporations and financial institutions in the afflicted economies. Consequently, the central governments of most Asia–Pacific nations, along with international organizations such as the OECD, implemented corporate governance reforms throughout the region.[1] The effectiveness of these governance reforms is an empirical question because business environments in this region are heterogeneous and Asian companies have many unique features, the most notable among them being the concentrated ownership and direct and indirect control exercised by the firms' founding families.

In this paper, we provide empirical evidence on the relation between control, ownership structure and firm value for all industrial companies that were publicly traded on the Thai stock exchange in 2005. We find that Thai family companies developed pyramidal ownership structures after the financial crisis of 1997, probably in response to reductions in their ownership holdings. In particular, we find that the governance measures mandated in Thailand, and subsequently adopted by Thai family firms, are not as effective in mitigating agency conflicts in this new opaque environment as they have been shown to be in the US. We also develop a corporate governance index that we show is a more effective measure of

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[1] There is recent empirical evidence of an association between adoption of internationally accepted corporate governance practices and firm valuation in these Asia–Pacific economies. See, for example Cheung et al. (2010) who examine large Chinese firms, Black et al. (2006a, 2009) for example Korean firms, and Cheung et al. (2007, 2011) for Hong Kong firms.

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compliance with good governance practices in the Thai business context than other, conventional measures of effective governance. However, even this governance index appears to be associated with value only when companies do not have a pyramidal ownership structure, suggesting that Thai families are able to manipulate governance measures when they have high voting control over their firms.

Recent anecdotal and research evidence document that family firms in the US outperform non-family firms.[2] Founding families have considerable wealth invested in their firms and, thus, have an incentive to manage the firm in ways that improve value. On the other hand, families and founders may use their greater control over decision rights to expropriate wealth from minority shareholders, resulting in a decrease in value.[3] Family firms in Thailand, however, operate in a very different environment from that in the US. Recent empirical research (La Porta et al., 2000b, 2002) provides evidence that companies with controlling shareholders have lower valuations in civil law countries, like Thailand, where minority shareholders are less well protected from expropriation by a controlling shareholder, compared to valuations in common law countries, like the US. Mitton (2002) argues that in an environment where legal protection for outside shareholders may be insufficient, the firms themselves can pre-commit to not expropriating wealth from minority shareholders by implementing appropriate corporate governance measures. For instance, such family firms could increase the number of independent directors on the board. The foregoing argument suggests that implementing appropriate governance measures may be particularly important in East Asian countries, where families commonly tend to own controlling interests in firms and legal protections for minority shareholder rights are limited. The issues that emerge are twofold. First, what measures of governance are appropriate benchmarks in an environment where implementation of good governance practices is hard to measure and monitor? Second, is compliance with prescribed measures of governance effectiveness sufficient to mitigate agency problems between majority and minority shareholders in these East Asian family firms or do pyramidal ownership structures and extra-contractual arrangements between family members and directors allow subversion and manipulation of these governance measures, rendering them ineffective proxies for value creation?[4] In other words, is the *form* of governance measures adopted by these firms consistent with the *substance* of what such measures are intended to accomplish?

Previous studies on governance arrangements in Thai family firms have generally focused on the period before the Asian financial crisis in 1997 (Bertrand et al., 2008; Wiwattanakantang, 2001). Before 1997, founding families held significant proportions of the outstanding shares and had full control over their businesses. Consequently, these families may have had no need to employ complicated ownership structures, such as pyramids. In corroboration, Claessens et al. (2000) document that Thai companies rarely employed a pyramidal ownership structure prior to 1997. However, recent changes in the characteristics of Thai family firms have affected the nature and extent of corporate family ownership and control. Specifically, many firms in Thailand experienced financial difficulties and some went bankrupt following the Asian financial crisis (Zhuang et al., 2000). As a result, some of these firms, including family firms, had to raise additional capital and restructure themselves after 1997, which, in turn, led to reductions in family ownership.[5] More importantly, many publicly traded family firms have also implemented pyramidal ownership structures, probably because they wished to counter the dilution in control arising from reductions in their shareholdings. Based on these considerations, we expect that family firms in Thailand are no longer the homogeneous group of firms with similar characteristics that they were prior to 1997. In particular, the nature and extent of agency problems, and corresponding value consequences, can vary across family firms. Because of these new institutional settings, we expect that our post-1997 analysis of these family firms can add additional insights and make a significant contribution to the literature.

In our analysis, we classify industrial companies that were publicly traded on the Thai stock exchange in 2005 into four groups, based on the extent of family ownership and the presence of pyramidal ownership structures.[6] Of the total sample of 216 firms, we find that firms with high family ownership are associated with lower values of Tobin's q. In particular, these high family ownership firms have an average q value that is lower than the mean q for low family ownership firms.[7] This difference is not only statistically significant, but also economically significant. Past research conducted on US firms (e.g., Yermack, 1996) has revealed a positive relation between conventional governance variables, such as board size and firm value. However, we find no such relation between conventional governance variables and q for Thai firms. We conjecture that this lack of association between broad governance measures and q for our sample firms arises because Thai family firms only maintain the external trappings of good governance practices, such as having several directors labeled as independent, while

[2] Anderson and Reeb (2003) document superior performance of family-owned firms among S&P 500 firms, across seven years (1992–1999). The improved performance is further increased when a family member holds the CEO position rather than an outside manager. An article in Business Week (November 10, 2003, p. 100) reports that one-third of the S&P 500 firms have founding families involved in management and these are the best performers. Villalonga and Amit (2006) and Perez-Gonzalez (2006) find that founder-controlled firms are associated with higher values which decline when these firms are managed by heirs.

[3] Demsetz and Lehn (1985) argue that founder or family control may be exercised because of "amenity potential", the non-pecuniary benefits that family members gain from control. However, because this leads to entrenchment, family control may also be associated with weaker management than that provided by professional managers. Johnson et al. (1985) find that positive unexpected returns are associated with the sudden demise of founder-CEOs and Morck et al. (1988) find that older firms with founders present among the management have reduced q values.

[4] For instance, Hwang and Kim (2009) provide evidence that social ties between managers and directors can weaken managerial pay-performance and turnover-performance sensitivity.

[5] As part of restructuring efforts, many families were forced to sell significant stakes in their firms. Others sought additional capital through strategic partnerships, often with foreign companies. The shareholdings of two of the largest commercial banks in Thailand were drastically restructured as the founding families gave up significant portions of their ownership stakes. Non-financial companies were also hard-hit. For example, at SHIN, a large stake in the nation's largest telecommunication company, owned by the former Prime Minister of Thailand, was sold to a consortium of Singaporean investors. BIG C, a large family-owned discount retailer, forged a business alliance with a foreign retailer by issuing shares to the new partner. NTS, a family-owned steel maker, merged its steel business into a new company jointly owned by another conglomerate. The founder of QH, a large real estate development company, sold a stake to the Government of Singapore Investment Corporation.

[6] Bertrand et al. (2008) study a sample of public and private firms using 1996 data, drawn from 93 Thai family groups. They show that family structure is important to value creation in Thai companies. Firms with more male heirs end up with sons having greater control and such firms are associated with lower levels of firm performance, especially if the founder is dead. Families with more sons show a greater gap between control and ownership rights. Our study differs in important ways from theirs because we focus only on publicly traded firms drawn from a period after the financial crisis of 1997 when family firms' ownership structures were drastically different. The study by Bertrand et al. (2008) consists of 528 firms, of which only 94 are publicly traded companies. More importantly, our study is able to assess the relative importance of control and management on agency costs while examining the relation between market value and a quantified and detailed governance index.

[7] As anecdotal evidence, Studwell (2007, p. 24) reports, "Despite now bullish stock markets in the region, the billionaires-with their lousy corporate governance and manipulation of local banks to provide cheap and easy alternative sources of credit-also have contributed to the worst long-term emerging-market-equity performance in the world. From 1993-when the first significant international portfolio investments came into Southeast Asian bourses-to the end of 2006, total dollar returns with dividends reinvested in Thailand and the Philippines were actually negative".