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Substitutability and complementarity of corporate governance mechanisms in Latin America

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ABSTRACT

This research analyzes the relations between highly concentrated ownership structures, corporate governance mechanisms and firm value for a sample of Latin American firms. With concentrated ownership, the conflict of interest shifts from the principal-agent problem to a dominant-minority shareholder focus. To minimize the negative effects of ownership concentration on firm value, Latin American firms resort to a number of different corporate governance mechanisms including measures for leverage, takeover activity, board size, board independence, cross-listing, single/multiple-class shares, and the dual role of the CEO as chairman of the board. In addition, institutional investors assume monitoring roles and help curtailing asset expropriation.

1. Introduction

This research analyzes the relations between highly concentrated ownership structures, corporate governance mechanisms and firm value for a sample of publicly traded Latin American firms within a context of weak shareholder protection. The period of analysis, 2000–2006, is characterized by economic growth sustained by the expansion of foreign direct investment in a post-privatization era. The development of a private pension system initiated in Chile and subsequently expanded to more than 25 countries reinvigorated the capital markets which have become more attractive as a means of diversifying global portfolios. This work serves to advance the finance literature in several dimensions: a) the manuscript examines markets which have hitherto been ignored or at best simply characterized as having very weak governance structures[1]; b) it addresses endogeneity problems from the initial design through the data collection process; c) furthermore, it extends the literature on the interactions between governance mechanisms and firm value; and d) it develops new corporate governance measures, including novel effective firm ownership variables for these markets.

Emerging economies are typically characterized by weak shareholder protection and highly concentrated ownership structures which are relatively stable over time. With concentrated ownership, the conflict of interest shifts from the principal-agent problem to a dominant-minority shareholder focus. This conflict of interest is characterized by the potential for

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[1] In emerging economies shareholder's rights are protected by local stock exchanges, local securities and exchange commissions, and courts of justice, but these institutions are deemed to be weaker than in developed countries and are considered especially weak in countries under Civil Law regimes.

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asset diversion from the firms to dominant shareholders, thereby reducing overall shareholder value. Dominant shareholders may have both the capability and the incentive to expropriate minority shareholders. Moreover, they may reduce their proportional share costs of private consumption by widening the discrepancy between voting rights and cash flow rights. Several mechanisms such as pyramidal structures, multiple-class shares, and cross-holdings serve to exacerbate the discrepancy between voting rights and cash flow rights. Likewise, the organization of business groups facilitates asset diversion through legal related-party transactions. Manos, Murinde, and Green (2012) find a significant difference in the dividend policy decision of independent and group affiliated firms. On the other hand, due to high interest rates and excessive monitoring privileges to creditors, equity represents a preferred source of financing investment requirements when growing business opportunities exceed internally generated funds. Consequently, dominant shareholders reduce private consumption, and hold onto significant cash flow rights to signal the quality of investments and their commitment not to expropriate minority shareholders.

The separation of ownership and control allows investors to diversify their portfolios, and permits firms to reach a large investor base, thereby lowering the cost of future capital. At the same time, investors implement strategies to align the interests of dominant shareholders with their own interests. They channel monitoring efforts primarily through elected boards of directors and a number of – imposed or voluntarily adopted – corporate governance mechanisms. Ideally, external forces originated by competition in product markets and markets for corporate control also interact to discipline dominant shareholders. However, any individual corporate governance mechanism may fail in given circumstances. The board of directors may be captured by dominant shareholders; it may have too many or too few members, or appoint directors who are undertrained or too busy. Boards may also fail to provide adequate compensation for both board members and executives to promote the redistribution of excess firm value to shareholders. Similarly, market regulation is ineffective if its scope is too narrow or its provisions are feeble or out-of-date, and the rule of law is not enforced.

Blockholders (large outside investors) are also potentially subject to expropriation. Unlike minority shareholders, some blockholders have the potential to prevent asset diversion, thereby increasing shareholder value. However, others may negotiate with dominant shareholders to obtain a portion of the private benefits. Blockholders' identity, their stake in the firm and the value of the stake with respect to the total value of their portfolio determine the behavior of the blockholders. La Porta, Lopez-de-Silanes, and Shleifer (1999) analyze the problem of monitoring families and Bennedsen and Wolfenzon (2000) assume that blockholders are active monitors rather than passive investors. My approach extends this analysis, and focuses on the parties whose role it is to monitor the dominant shareholders. This research also examines the motivations for outside investors to take large stakes to finance the firms' activities. If low ownership concentration increases market liquidity, facilitates takeovers, and prompts exit from troubled positions, blockholders are incurring additional costs when holding undiversified portfolios. Because they face expropriation risks, other governance mechanisms should be in place to secure risk-adjusted return on investments, increase shareholder protection and reduce market undervaluation. For example, Bennedsen and Wolfenzon (2000) find that optimal ownership structures have a single large shareholder or few large shareholders of similar size. In addition, Bathala, Moon, and Rao (1994) suggest that the “exit” solution by unsatisfied institutional investors has become more difficult due to transaction costs and portfolios heavily weighted on firms making up the index. Therefore, increasing monitoring becomes a viable alternative.

This research contributes to the finance literature by focusing in five Latin American markets: Brazil, Chile, Colombia, Peru and Venezuela as a regional investment destination for local and foreign business groups. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) report the aggregated ownership by the three largest shareholders in Brazil (57%), Chile (45%), Colombia (63%), and Peru (39%) for the ten largest non-financial firms. The capability to expropriate minority shareholders hinges on the

Table 1
Primary control levels. Control 50 equals 1 for firm-year observations in which dominant shareholders control more than 50% of the voting rights. Control 80 equals 1 for firm-year observations in which dominant shareholders control more than 80% of the voting rights. 922 observations, 220 firms from Brazil, Chile, Colombia, Peru and Venezuela for 2001–2006.

Country	Variable	2001	2002	2003	2004	2005	2006
Total (922)	# Observations	159	159	154	170	166	114
Brazil (442)	# Observations	73	76	69	70	78	76
	Control 50	54	59	53	56	60	55
	Control 80	25	26	22	22	22	23
Chile (221)	# Observations	38	38	36	41	38	30
	Control 50	13	15	14	19	17	12
	Control 80	4	4	4	4	3	1
Colombia (88)	# Observations	17	17	16	20	18	
	Control 50	5	8	7	9	5	
	Control 80	1	2	0	2	1	
Peru (138)	# Observations	23	28	24	30	27	6
	Control 50	11	14	14	17	15	2
	Control 80	3	4	4	6	5	1
Venezuela (33)	# Observations	8		9	9	5	2
	Control 50	3		4	5	2	1
	Control 80	0		0	0	0	0