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Ownership structure and the cost of corporate borrowing ☆

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ABSTRACT

This article identifies an important channel through which excess control rights affect firm value. Using a new, hand-collected data set on corporate ownership and control of 3,468 firms in 22 countries during the 1996–2008 period, we find that the cost of debt financing is significantly higher for companies with a wider divergence between the largest ultimate owner's control rights and cash-flow rights and investigate factors that affect this relation. Our results suggest that potential tunneling and other moral hazard activities by large shareholders are facilitated by their excess control rights. These activities increase the monitoring costs and the credit risk faced by banks and, in turn, raise the cost of debt for the borrower.

1. Introduction

The separation of ownership and control has long been viewed as the key to the analysis of the modern corporation, in which the classic agency conflict is set between shareholders and managers (Jensen and Meckling, 1976). It has been widely documented, however, that for most publicly traded firms around the world, ownership and control often vest with dominant shareholders.[1] Moreover, the widespread use of pyramid ownership structures, dual-class shares, and cross-holdings typically enables large shareholders to exercise effective control over a company with a relatively small direct stake in the cash-flow rights.[2] In such firms, the primary agency conflict is between large controlling shareholders and other investors, and the divergence between control rights and cash-flow rights

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[1] La Porta, López-de-Silanes, and Shleifer(1999) examine the ownership structure of large corporations in 27 wealthy economies and find that the firms are typically controlled by families or the state. Claessens, Djankov, and Lang(2000) examine the separation of ownership and control for 2,980 corporations in nine East Asian countries and find that more than two-thirds of firms are controlled by a single large shareholder. Faccio and Lang (2002) study 5,232 corporations in 13 Western European countries and find similar results.

[2] For example, see La Porta, López-de-Silanes, and Shleifer (1999), Claessens, Djankov, and Lang (2000), Faccio and Lang (2002), and Lemmon and Lins (2003).

creates a separation of ownership and control that aggravates these conflicts (Shleifer and Vishny, 1997).

Despite the widespread divergence between control and cash-flow rights (the "control-ownership wedge"), there is limited evidence on the financial implications of the wedge. Most studies focus on the relation between the control-ownership wedge and corporate valuation and find that the deviation between control rights and cash-flow rights is associated with lower firm value.[3] Examining the link between the control-ownership wedge and firm value is one way to gauge the financial implications of the separation of ownership from control. Empirical estimation of this relation does not, however, identify *how* the wedge affects corporate values. Moreover, the extant literature on controlling shareholders and the consequences of ownership-control deviation typically takes on the perspective of equity holders. In this paper, we identify an important channel through which the divergence between control rights and cash-flow rights affects firm values. Specifically, we examine the impact of control rights-cash-flow rights divergence on firms' costs of borrowing.

Existing theories propose a straightforward connection between the control-ownership wedge of a firm's controlling shareholder and the firm's ability to raise external debt finance. Since large shareholders pursue their own interests, they may seek to expropriate other investors by diverting firm resources for their own use, transferring assets and profits out of companies, or committing funds to unprofitable projects that provide private benefits. Their incentives to engage in "tunneling" and other moral hazard activities are especially severe when their control rights are significantly in excess of their cash-flow rights because they have a greater ability to divert corporate resources for private benefits while at the same time bearing a smaller proportion of the financial consequence of such activities (Shleifer and Vishny, 1997; Johnson, La Porta, López-de-Silanes, and Shleifer 2000a).[4] Many of these activities increase the probability of costly lower-tail outcomes,[5] thus increasing the expected costs associated with financial distress and bankruptcy.[6] In addition, potential tunneling activities could impair the value of collateral, which in turn reduces the recovery rates in the event of a default.[7] Since creditors incorporate expectations about financial distress costs and bankruptcy states into their lending decisions, a higher likelihood of negative outcomes results in higher financing costs. Moreover, Shleifer and Vishny (1997) argue that the problem of expropriation by controlling shareholders might become more severe when other investors are of a different type (e.g., creditor). Holding cash-flow rights constant, greater control rights (i.e., larger wedge) may provide extra risk-taking incentives to controlling shareholders because they may be able to use their effective control rights to divert the upside gains for private benefits while leaving the costs of failure to creditors. This potential effect aggravates the agency problem faced by the creditors and therefore, might also result in an increase in the cost of debt financing.

In this paper we examine the relation between the control-ownership wedge of a firm's largest shareholder and the firm's cost of bank debt using a new, hand-collected data set on corporate ownership and control of 3,468 firms in 22 Western European and East Asian countries during the period from 1996 to 2008. We compute the cash-flow and voting rights of the ultimate largest owner of each firm and obtain detailed information on 13,331 bank loans made to the sample firms. We focus on the 22 countries in East Asia and West Europe because firms in these countries exhibit far more divergence between cash-flow rights and control rights than do U.S. firms and because previous studies based on these countries show a significant value discount for firms with deviation between cash-flow rights and control rights.[8] We focus on private credit agreements in the syndicated loan market (rather than, say, bond indentures) because this market has been the largest source of corporate financing worldwide over the past two decades (Ivashina, 2009). Indeed, Nini, Smith, and Sufi (2009) report that roughly 80% of all public firms in the U.S. have private credit agreements in place, while only about 15% of those firms have public debt, and this difference is

[3] For instance, Claessens, Djankov, Fan, and Lang (2002) find that a one-standard-deviation increase in the excess control rights of the largest shareholder is associated with a 5% decrease in firm value. Lemmon and Lins (2003) show that during the East Asian financial crisis, the stock returns of firms with separated control and cash-flow rights are 10–20% lower than those of other firms. In more recent studies, Laeven and Levine (2008) examine European firms with multiple large owners, and Gompers, Ishii, and Metrick (2010) study excess control rights for corporate insiders; both papers find similar patterns.

[4] As discussed in Johnson, La Porta, López-de-Silanes, and Shleifer (2000a) and Johnson, Boone, Breach, and Friedman (2000b), the tunneling activities by controlling shareholders include various self-dealing transactions such as outright theft or fraud, expropriation of corporate opportunities, transfer pricing, asset sales or transfers to controlling shareholders or other corporations they control at favorable prices, loan guarantees using the firm's assets as collateral, etc. Johnson, La Porta, López-de-Silanes, and Shleifer (2000a) report a vivid example in the case of Barro, a Belgian company, with Flambo as its controlling shareholder. Minority shareholders of Barro sued Flambo, arguing that Flambo pledged Barro as collateral to guarantee Flambo's debt, forced Barro to acquire new shares of Flambo, withdrew money from Barro's accounts without repayment, diverted an important contract from Barro to Flambo, and used Barrow's utilities without payment. More examples can be found in Lemmon and Lins (2003).

[5] See, for example, Gilson and Villalonga (2009), for a recent case on Adelphia Communications Corporation's bankruptcy, the eleventh largest bankruptcy case in history. The case highlights the potential expropriation of other investors by large, controlling shareholders such as founding families, who retain their controls through the dual-class share structure.

[6] These costs include direct bankruptcy costs, such as lawyers' charges, administrative and accounting fees, expert witness expenses, as well as indirect costs due to the potential loss of customers, suppliers, employees, and growth opportunities (Purnanandam, 2008). Indirect financial distress costs can be much greater than direct costs, amounting to 20% of firm value in some cases (Bris, Welch, and Zhu, 2006).

[7] As summarized by Friedman, Johnson, and Mitton (2003), many bankruptcy cases in countries such as Russia and Thailand were associated with complete looting by controlling shareholders so that creditors received almost nothing when the firms went out of business. Similar outcomes in Mexico were reported by La Porta, López-de-Silanes, and Zamarripa (2003). Akerlof and Romer (1993) provide a theoretical discussion.

[8] See, for example, Claessens, Djankov, and Lang (2000), Claessens, Djankov, Fan, and Lang (2002), Faccio and Lang (2002), Lemmon and Lins (2003), and Laeven and Levine (2008).