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Ownership structure, corporate governance and analyst following: A study of French listed firms ☆

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Abstract

This study investigates the effects of some characteristics of the French corporate governance model – deemed to foster entrenchment and facilitate private benefits extraction – on the extent of analyst following. The results show that analysts are more likely to follow firms both with high discrepancy level between ownership and control and those controlled through pyramiding. These findings provide empirical support to the argument that minority shareholders value private information on firms with high expropriation likelihood, asking thence for more analyst services. Additional findings show that analysts are reticent to follow firms managed by controlling family members. This is, in part, explained by these firms' reliance on private communication channels rather than public disclosure, producing a poor informational environment.

JEL classification: G32; G34; M41

Keywords: Corporate governance; Private benefits of control; Pyramids; Analyst following

1. Introduction

Since 1997, number of papers have been published that investigate the effects of systematic cross-country legal and judicial differences, such as law origin and enforcement quality, on capital market development (La Porta et al., 1997, 1998) and corporate governance practices around the world (La Porta et al., 1999, (hereafter LLS) and La Porta et al., 2000). These seminal papers spawned an important stream of theoretical and empirical research on a number of subjects, including how investor protection disparities among countries affects corporate valuation (Claessens et al., 2002), information asymmetry and stock liquidity (e.g., Attig et al., 2006), earnings informativeness (Fan and Wong, 2002), earnings management (Leuz et al., 2003; Haw et al., 2004a), and analyst activity (Chang et al., 2001; Lang et al., 2004; Haw et al., 2004b). Here, we further explore this last subject of analyst activity.

The present study is built upon advances gleaned from recent international corporate governance research. Chang et al. (2001) consider both country-specific institutional factors and firm-level organizational attributes as determinants of analyst activity. They show that a country's legal system and the quality of its accounting disclosures account for the variations in the extent of global analyst activity. Specifically, they demonstrate that analyst coverage is significantly lower in civil law countries (such as France) than in common law countries. They employ the anti-directorship index developed by La Porta et al. (1997) to measure the extent of investor protection level. This measure, however, assesses only the potential protections a country's legal rules offer its external investors. It

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paints a bleak picture for investor rights in civil law countries and shrugs off those practices the firm has actually adopted, such as bylaws, disclosure policies, and ownership-control structures. In fact, some firms may commit themselves to alleviating agency costs that may arise between insiders and external shareholders by evading some control patterns.[1] More recently, Lang et al. (2004) suggest that how governance is exercised, i.e., ownership-control structure, can serve to explain what catches financial analysts' attention. They document that firms exhibiting poor internal governance (e.g., when the family/management is the largest shareholder) are less likely to be followed by analysts. This relation is interpreted as a reluctance of analysts to follow firms with potential incentives to hide or misreport information. Furthermore, this relation was found to be much more acute in countries with weak investor protection environments. On the contrary, Haw et al. (2004b) find that analysts prefer following firms where expropriation is likely, i.e., high cash flow-control divergence. These studies do not provide insights into the systematic differences in analyst activity amongst firms within any specific country.

In the current study, we provide evidence that analyst following varies substantially across firms within the same country. We extend this line of research by investigating the effects of pyramiding and family member participation in the management on the extent of analyst following. Moreover, we supplement prior cross-country findings by examining the effects of control concentration and excess control on analyst coverage in the context of the French marketplace.

In contrast to recent studies, we use firms from one country – France – instead of using a cross-country analysis. This research design presents several advantages. First, doing so allows us to have a more homogenous sample of firms facing similar legal and extra-legal institutions. Countries included in the cross-country studies may not have enough in common to justify their being included in the same regression. Hence, the assumption that observations need to be drawn from a distinct population is likely to be violated, which casts doubt on the inferences made (e.g., Levine and Zervos, 1993). Second, many variables used in cross-country research as surrogate measures for broad concepts (e.g., the shareholder's protection environment) are likely to catch other country-specificities, such as cross-cultural differences, accounting and auditing standards differences, and the orientation of the economy. As a consequence, regression analyses may be plagued by omitted correlated factors, calling into question the results and conclusions. In this respect, Bushman and Smith (2001) point out that the results of cross-country studies should be regarded as suggestive of the underlying relations and interpreted with "eyes wide open." Finally, since Haw et al. (2004b) use a cross-country design and provide results for the whole sample; no clear conclusion can be made regarding the relationship between analyst following and cash flow-control divergence within a specific country.

This paper uses detailed ownership and voting data from France. The sample covers 393 non-financial French listed firms that are followed at least by one analyst during the period 1999–2000. France, the cradle of the French legal system, provides an interesting laboratory for several reasons. First, the French judicial environment is deemed to not adequately shield minority shareholders due to its weak legal protection rules and to its inefficient law enforcement system (La Porta et al., 1998). Analyst following in this context may act as a valuable monitoring device. Second, the French listed firms show a highly concentrated ownership structure and are often controlled through pyramiding and/or double voting shares.[2] The largest shareholder is typically a family owning control rights in excess of its cash flow rights, and is often at the helm of the firm (Faccio and Lang, 2002). These characteristics suggest that the striking agency problem is not the one between managers and shareholders but that between the large controlling shareholders and minority shareholders. Third, Nenova (2003) shows evidence that the private benefits of control are particularly significant in magnitude in France. She reports a substantial average value of control-block votes, which ranges between 27% and 28% of the firm market capitalization. Finally, by using France as an experimental setting, we can use a unique database that overcomes the data shortcomings of previous studies. In fact, we include in our sample the affiliates of foreign firms, we consider the non-traded high voting shares (widespread among French listed firms), and we trace pyramids back beyond unlisted firms. Together, these minimize the measurement errors in the ownership and control variables present in the other related studies.

Consistent with prior cross-country studies, we find that analyst following is positively associated with cash flow-control divergence and negatively associated with concentrated control. These results suggest that analysts respond favorably to the increased demand of their services by minority shareholders when the expropriation likelihood is substantial. However, they prefer avoiding firms with a concentrated control due to difficulties in gathering information. Interestingly, we show that family firms, regardless of who is managing them, are associated with lower analyst following, all else being equal. This result is consistent with the argument that these firms resolve information asymmetry through private communication channels, thus increasing the costs of analyst following. More importantly, we provide evidence that pyramid firms enjoy greater analyst

[1] For example, family firms may choose a more transparent structure by hiring professional managers, streamlining pyramids by reducing the number of levels, or opting for the one-share-one-vote rule despite the fact that dual-class shares, pyramiding, and cross-holdings are not forbidden in France.

[2] Other mechanisms, such as cross-holdings and non-voting shares, are virtually nonexistent.