OWNERSHIP STRUCTURE AND MARKET VALUATION OF FAMILY GROUPS IN CHILE*

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Abstract

In this paper I provide a summary description of corporate structure in Chilean firms and explain the evolution of conglomerates and capital markets in the Chilean economy. Specifically, I look at the control mechanisms and the identity of controllers of listed non-financial companies in Chile. Using a database developed by Lefort and Walker (2000, 2003b), I look at the relationship between family ownership and control and market valuation of listed firms in Chile. The evidence provided in this paper indicates, that in the case of the highly concentrated Chilean companies, family management of a company is associated to a market discount. This evidence is consistent with the hypothesis of imperfect correlation of talent across generations. However, as I explained earlier in the paper, most Chilean groups have less than 30 years of existence and therefore, the succession problem is not likely to be very important in Chile.

Keywords: ownership structure, market valuation, family groups, Chile

*Paper prepared for the workshop on Family Business in Developing Countries: Cases of Asia and Latin America, hosted by IDE-JETRO, Makuhari-Chiba, Japan, January 16-17, 2004. The author thanks excellent comments by Koichi Kitano, Makoto Abe and other participants at the workshop. Ronald Espinosa provided outstanding research assistance.
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1. Introduction

The growing interest in corporate structure and governance practices around the world has also reached Latin America, both from positive and normative perspectives. In particular, the Chilean case presents at least three interesting features that make its study specially relevant in terms of policy recommendations for this country and others in the region. First, the Chilean corporate structure presents highly concentrated ownership and widespread presence of conglomerates that use pyramid structures to separate cash from control. Second, from the legal point of view, the Chilean system has a civil origin with inexistent self-regulation practices regarding capital markets. Recently, an amendment to Securities Market Law and Corporation Law, better known as the OPA Law, was passed with the intention to improve corporate governance in Chile. Finally, the Chilean capital market is relatively developed with a large participation of institutional investors for more than two decades. In addition, the identity of controllers has been changing during the last few years. Although domestic families are still very important players, control has been passing to teams of executives and to foreign companies. In most cases, the only relevant minority shareholders are institutional investors both domestic and foreign.

Family business is commonly viewed as a second-best solution to agency problems related to the potential expropriation of shareholders by managers. In countries with poor shareholder protection, the owners of companies prefer to hold on to control, even if an outsider would be more appropriated to manage the firm. The agency problem in the relationship parent/son is assumed to be less important than in the relationship owner/manager because of trust and because the prospect of succession helps to align incentives between the parent (principal) and his/her son (agent).

In this paper I provide a summary description of corporate structure in Chilean firms and explain the evolution of conglomerates and capital markets in the Chilean economy. Specifically, I look at the control mechanisms and the identity of controllers of listed non-financial companies in Chile. Using a database developed by Lefort and Walker (2000, 2003b), I look at the relationship between family ownership and control and market valuation of listed firms in Chile. I perform panel data regression analysis to estimate the impact of proxies of corporate governance practices at the firm level and family ownership on Tobin's q measure of corporate valuation. I find that firms mostly owned and managed by families tend to present lower market valuation after controlling for other variables.

Section II of the paper discusses the theoretical and empirical literature and reviews the main hypothesis related to the effect of family control on firm performance. Section III describes the data set employed. Section IV and V give a summarize view of corporate structure and the legal framework in Chile. Section VI presents the empirical procedure and results. Section VII concludes.

2. Conceptual framework and working hypothesis

It is well known by now that, against popular wisdom, the standard Bearle and Means (1936) firm characterized by dispersed ownership is a rare phenomenon in most economies (La Porta, Lopez-de-Silanes, Shleifer and Vishny, 1999), and certainly in Latin American economies. Lefort (2003a) provides a simple measure of ownership concentration for Latin American countries obtained by looking at the percentage of shares held by the largest shareholders of a set of companies. The evidence is clear. The largest single shareholder in these firms holds, on average, 53% of total shares, and the five largest shareholders add up to almost 80% of total shares. This evidence probably underestimates actual ownership concentration for two reasons. On the one hand, the large firms considered in the sample tend to be less concentrated than smaller firms and, on the other hand, usually several of the five largest shareholders represent, in fact, the same beneficial owner. In addition, most firms in emerging economies are linked in some way or another to an economic group or conglomerate that exercises tight control over the firm and owns a large fraction of its shares. The identity of controllers has been changing during the last few years. Although domestic families are still very important players, control has been passing to teams of executives and to foreign companies. In most cases, the only relevant minority shareholders are institutional investors both domestic and foreign. Lefort (2003a) also presents evidence regarding the identity of controllers in large listed Latin American companies, the degree of affiliation to conglomerates and the extent of the separation of cash flow and control rights. His results show two interesting features. First, family owned firms in most Latin American economies are the predominant form of corporation even among large listed firms. However, during the last 5 to 7 years, there has been an important increase in foreign owned companies. The case of Argentina is remarkable presenting a majority of companies foreign controlled. Second, on average, almost 80% of large listed firms are affiliated to an economic group. Although, these groups use very different forms to exercise control, they all tend to hold a large fraction of cash flow rights of the companies they control. Two main features of conglomerates or "grupos" are key to understand the strengths and weaknesses of these very common corporate structures. On the one hand, although conglomerates may be structured in different ways, they tend to be used to effectively separate cash from control rights. That is, the controlling shareholders of a conglomerate usually achieve disproportionate voting power through pyramids, dual class shares and cross holdings, retaining control of the affiliated companies but leveraging their cash investments in those companies. On the other hand, conglomerates are characterized by the lack of separation between ownership and managerial activity. That is, it is generally the case that affiliated firms are not only controlled but effectively managed by their owners. In many cases, specially in emerging economies, the owners are part of the founder family of the company.

In this section, I briefly review both the theoretical and empirical literature on conglomerates and family business and discuss the main conclusions regarding incentives structure and firm economic performance.

A. Conglomerates

A growing literature in corporate governance and corporate strategy has shifted its focus away from the standard agency problem between managers and dispersed shareholders, and looked closely to the relationship between minority and majority shareholders. This is especially relevant in the case of emerging economies such as Chile. In particular, it has been argued that concentrated structures or economic groups are prone to carry inefficient investment and generate minority shareholder expropriation, especially when the controlling shareholders of these groups exercise control through complex mechanisms such as pyramid schemes, cross-holdings and dual class shares. In those cases, the agency problem is exacerbated because, on the one hand, ownership concentration insulates the controller from the market for corporate control, and on the other hand, control is executed by a shareholder that holds a relatively small fraction of the cash-flow rights (Bebchuck (1999) and Wolfenzon (1999)). An incomplete list of papers analyzing the effect of conglomeration in corporate governance and firm performance in emerging economies includes Khanna and Palepu (1999), Ghemawat and Khanna (1998) and Lefort and Walker (1999b, 2000) for the case of Chile, Valadares and Leal (2000) for Brazil, Castaneda (2000) for Mexico, Khanna and Palepu (1999a, b, c) for India, and Claessens et al. (1999, 2000) for most East Asian economies (and Chile).

Interestingly, many of these studies recognize that one of the most salient characteristics of conglomerates in emerging economies is that they are persistent in time, and able to adapt to most changing situations. Khanna and Palepu (1999) for India and Chile and Lefort and Walker (1999b) for Chile have shown that conglomerates have been able to grow and increase their scope and self-intermediation practices even during times of fierce economic reform and deregulation. This kind of evidence has supported a more favorable view of conglomerates in emerging economies sustaining that economic groups are a natural and efficient way for firms to deal with imperfect capital markets, poor institutions, corruption and other imperfections that plague emerging economies. In this context, economic groups arise in order to fill the voids left by (or to take advantage of) poor institutions. In particular, internal capital markets, that is, the headquarters allocation of funds to the different business units of the conglomerate creates value in a credit constrained world (Stein (1989)). Other financial synergies arise because of the possibility for conglomerates to liquidate assets of specific units in response to a general downturn (Shleifer and Vishny (1992)), and because of risk diversification that might be valuable to investors in economies with imperfect capital markets. There are also operational synergies generated through conglomeration. They might be related to economies of scale and scope in product and factor markets arising because of poor basic services like power, postal or others. It might be also related to poor consumer protection and the advantage of group branding. One of the most cited reasons for conglomerates in emerging markets is the advantage they create to deal with a corrupt government, a highly regulated economy and a poor judiciary system (Khanna and Palepu (1997)).

We have now a better understanding about the ownership and control structure of firms in most emerging economies, and we have at least two competing conceptual frameworks in order to explain the costs and benefits of conglomerates in emerging markets. It is not surprising, then, that an empirical literature has developed to try to ascertain whether the affiliation to a conglomerate constitutes good news for investors. Some of the most important contributions trying to explain the performance of business groups in emerging markets include: Khanna and Palepu (1999a, 1999b) find that group affiliation improves firm economic performance in India and Chile. They also find that the degree of diversification of the conglomerate increases performance only after it has reached a certain threshold. Khana and Palepu (1999c) find that in Chile and India the performance of groups increased after economic reform was performed, indicating that part of the benefits of affiliation are not related to poor economic environment. Khanna and Rivkin (2000) look at firms in 18 emerging economies finding that affiliated firms perform better in 6 countries, worse in 3 and equally in 5. They also find that returns of firms belonging to the same conglomerate tend to move more closely when compared to other firms. Claessens, Djankov and Klapper (1999) find that East Asian group structures are used to diversify risks, while Claessens, Djankov, Fan and Lang (1999) show that East Asian firms affiliated to conglomerates present a 4% average value discount, and that this discount arises in firms whose owners have more voting than cash-flow rights. Thomsen and Pedersen (2000) look at the 435 largest European companies and find that ownership concentration has a non-linear relationship with performance, where too much concentration reduces performance. Finally, Lefort and Walker (2003) find preliminary evidence for Chile that firm affiliation to a group tends to decrease firm value and that this effect is partially reduced when there is little separation between cash flow and control rights.

B. Family business

In this paper, I consider that a family business is a company in which a majority of shares are held directly or indirectly by members of a family or clan and, more importantly, a company whose manager are also members of that family. We now know that family business are pervasive around the world not only at the small firm level. La Porta, Lopez-de-Silanes, Shleifer and Vishny (1999) looked at the ownership structure of the 20 largest listed firms in 27 relatively wealthy economies. They found that, on average, families exercise control in 30% of these companies. This figure is much higher for the Latin American economies of the sample: 65% in Argentina and 100% in Mexico. Moreover, the authors show that overall, in 70% of this very large family owned companies, family members were directly involved in top management positions.

Despite this evidence, it is generally accepted that, in a frictionless world with perfect markets, there is no reason for owners to manage their own firms. In such a world, owners should select managers based only on their managerial talent regardless of any type of family relationship. Hence, while the allocation of cash flow rights should depend on the distribution of wealth and on risk diversification considerations, the allocation of managers to firms should depend on the distribution of managerial talent.[1] For instance, Lucas (1978) argues that in a perfect world more talented managers should manage larger assets.

Then, why is it so common to find family owned and managed firms in most countries around the world? The answer has to do with economic incentives, asymmetric information and a second-best solution to agency problems related to the potential expropriation of shareholders by managers. In this context, Burkart, Panunzi and Shleifer (2002) argue that in countries with poor shareholder protection, the owners of companies prefer to hold

[1] See Caselli and Gennaioli (2002) for an excellent discussion of family business, dynastic management and economic performance.

on to control, even if an outsider would be more appropriated to manage the firm. In addition, Chami (2001) argues that there is less of an agency problem in the relationship parent/son than in the relationship owner/manager. This is mainly because of trust and because the prospect of succession helps to align incentives between the parent (principal) and his/her son (agent). An interesting perspective to this discussion arises when one considers the possibility that the heir is actually untalented. Caselli and Gennaioli (2002) convincingly argue that unless managerial talent is highly correlated across generations and, therefore, the distributions of wealth and managerial talent coincide, "it is inevitable that assets will sooner or later end up in the wrong hands." Supporting this assertion, Morck, Strangeland and Yeung (2000) find that a sample of Canadian firms managed by family members of the founder under perform similar US firms with dispersed ownership.

3. Data sources and methodology

The data base was constructed using several sources. Complete accounting and financial information is provided by the FECUS plus database prepared by the Santiago Stock Exchange for all listed companies. In some cases it is necessary to either contact firms directly or to use other public records in order to complete missing information. This database also provides information about main shareholders, board members and a set of corporate features and policies. Some historical market information for these companies can be obtained from ECONOMATICA or directly from the Santiago Stock Exchange. The SVS (main supervisory entity) provides data on corporate actions and material information reported to the SVS. The "Official Gazzette Database" (Diario Oficial) allows identifying beneficial ownership of the different investment companies used by the controllers of Chilean listed companies. This information is an important input in the conglomerate consolidation procedure.

In this paper I use the data base of Lefort and Walker (2000, 2003) that considers the universe of Chilean corporations registered at the Superintendencia de Valores y Seguros (SVS) for the years 1990, 1992, 1994, 1996, 1998, 2000 and 2002. The database comprised a total of 246 public companies listed at least one year during the period considered. In previous work, we looked at the balance sheets and shareholder identification information submitted by these firms to the SVS, and used this information to build the "chains of property" that characterize Chilean conglomerates through a detailed analysis of groups' direct and indirect holdings in each corporation. Through this procedure we obtained consolidated economic balance sheets at the group level, allowing us to avoid double counting certain investments. We also constructed economic balance sheets at the individual firm level.

The first step in building the chains of property consists in identifying corporations associated to specific conglomerates. I use the definition of group as in Lefort and Walker (2003) and extend it for the year 2002, comprising approximately 50 different economic groups of very diverse nature in terms of size, number of public companies controlled, identity of controller and others.

There are two considerations regarding the sample of conglomerates. First, this database does not include banks or other financial institutions like pension fund administrators and insurance companies, which probably tends to underestimate the importance of groups. However, since groups cannot consolidate their activities around a bank, these holdings would just have to be added to the total without any additional consolidation. Second, it also excludes groups that are only comprised of "closed" (non-public) companies that are not consolidated by any public company. It may well be the case that a group in the sample has only one public company. Because of data limitations, we were not able of consolidating the non-public companies belonging to the groups in the sample.

As in previous studies, for each conglomerate in the sample I constructed a consolidated balance sheet identifying the consolidated debt and equity figures. In order to compute capital structure figures for Chilean corporations I value equity at market prices at the end of the year when possible. An important aspect of the consolidation procedure is the identification of all companies controlled by a group. In most cases, these companies are linked through pyramid schemes that must be properly identified in order to avoid double counting group assets.

As Lefort and walker (2000) showed, pyramid schemes are the most common way of achieving control in Chilean conglomerates, since cross-holdings are forbidden by law and dual class shares are relatively rare. In order to determine minority and controlling shareholders' investments in subsidiary and parent companies, as Lefort and Walker (2000), I use the information about the 12 most important stockholders provided by corporations to the SVS and the "Diario Oficial" to identify the owners of investment companies among the 12 largest shareholders of each corporation, associating them to different groups.[2] Therefore, the consolidated balance sheets of conglomerates consider also privately held investment companies (level 0 firms) under the assumption that they hold no debt. It is possible that these calculations underestimated the controlling shareholders' stake,

[2] When an investment company holds only shares of corporations of a particular group, we take that investment company as an investment vehicle of the group. Their shares are, therefore, considered part of the controlling shareholders' stake in the holding.

since some of the group holdings may be materialized through investment vehicles that do not appear among the 12 largest shareholders. However, considering that the 12th largest shareholder holds on average less than one percent of total shares, and that the 12 largest investors usually hold at least 80% of the company shares, it is very unlikely that this may introduce a substantial bias.

In the following sections I will summarize the most recent findings using this database.

4. Economic history and conglomerate structure in Chile

A. Events that have shaped corporate structure in Chile

There are several important economic and political events that have to be considered in order to understand the way that Chilean conglomerates have evolved through time.[3] Until 1973 capital markets as such did not really exist in Chile. Financial repression and credit rationing gave the rationale for the extensive use of internal capital markets and the subsequent apparition of bank-centered groups. In the mid-seventies, the first round of privatization took place at relatively attractive prices, in the context of a recently liberalized economy, a naïve legal environment and primitive capital markets. This gave incentives to the creation of significantly indebted groups or conglomerates. Following this period, the 1982 debt crisis is perhaps one of the most important events that have shaped the way in which Chilean corporations are organized even today. The crisis meant that most bank-based conglomerates became bankrupt. In addition, many important regulations were adopted as a consequence of the crisis. The debt crisis also implied that most productive firms were back in the hands of the state.

The second privatization round is another important event. It took place during the mid-eighties, implying some degree of equity market development, fueled by local pension funds and foreign investment funds. Important efforts were made in order to achieve a wide investor base (capitalismo popular). In theory, privatization of state-owned firms is likely to have important effects on the development of capital markets. Firms that before relied on centralized credit allocation may now opt for the bond and stock markets. Also, if the privatization process purposely considers a vast dispersion of property, higher transaction volumes in stocks are expected. Perhaps the most important economic event in terms of shaping financial markets and explaining capital markets evolution in Chile, was the early pension fund reform. Since its inception in the early eighties, significant pension funds have been accumulated in Chile, representing an important source of funds for companies that are channeled through the Chilean financial system.[4] Pension fund reform introduced a new actor, institutional minority investors, that have become a relevant counter weight to controlling shareholders. In addition, pension reform has meant that economic authorities have frequently had to modernize the existing regulations and institutions, trying to improve minority shareholder protection and capital markets functioning and supervision, among other issues.[5]

B. A brief history of the evolution of Chilean conglomerates

Conglomerates have been the traditional business structure in Chile for a long time. Their origins and evolution importantly respond to the political and economic events described earlier. During the first half of the 20th century a number of large state-owned companies were created in the context of a national plan of industrialization under the supervision of a public entity (CORFO). The privatization of these companies that took place much later gave origin to several of today's conglomerates. In addition, responding to financial repression and seeking cheap credit, several groups were created around banks during the fifties.[6] The socialist period of 1970-73 imposed severe conditions to the development and continuity of groups. However, Dahse (1979) and González (1978) identify for 1978 more or less the same groups as previous studies, although some important changes in property and new associations had taken place.

During the late seventies, the first round of privatization provided a new push to the creation of economic groups, mostly around banks.[7] However, the 1982-83 bank crisis implied a large shock for groups. Bank failures and state intervention caused the disappearance of several conglomerates, like Vial and BHC, and the reduction of others like Cruzat-Larraín. New laws and regulations, put in place in response to the debt crisis, greatly reduced the importance of banks for future groups.

The second privatization round that took place during the mid-to-late eighties produced an upsurge of new groups. The privatization process was

[3] Some of these issues are explained in detail in Lefort and Walker (2000a)

[4] Eyzaguirre y Lefort (2000) also refer to the close relationship between economic growth and asset accumulation in Chile.

[5] See Walker and Lefort (2001).

[6] Paredes and Sánchez (1994) summarize several studies regarding the evolution of groups over the years. Lagos (1961) identifies eleven large groups, all related to banks in 1958. For 1966, Garretón and Cisternas (1970) identify 19 additional groups, most of them presumably small family groups.

[7] The most important groups that appeared in that period were Cruzat-Larraín, BHC, and Claro. See Hachette and Lüders (1992).

implemented partly with the purpose of achieving disperse firm ownership. Pension funds were allowed to buy equity for the first time, but eligible firms had to adopt important statutory restrictions, particularly in terms of ownership concentration. Yet economic groups rapidly took control over most newly privatized firms. The large size of the firms being privatized in some cases implied associations of Chilean with foreign companies.[8,9] Only three groups have been present since the sixties: Matte, Angellini and Luksic.[10] However, eleven of the twelve groups that were present in 1988 were still present in 1998. This is just an indication that this period of high economic growth encouraged the appearance of new conglomerates. The stability in their number from 1996 on, jointly with the wave of acquisitions and the 1999 recession implied a reduction in the number of conglomerates. Since 1996 an increasing number of foreign corporations acquired domestic firms traditionally controlled by Chilean family business groups.

C. Control and capital structure of conglomerates in Chile

Unlike the U.S. and the U.K., corporate ownership in Chile is characterized by the high degree of ownership concentration. Furthermore, like in most emerging economies the identifying feature of corporate structure in Chile is the generalize presence of complicated structures or conglomerates called "grupos". Lefort and Walker (2003) hypothesize that the presence of "grupos" in Chile and some of their features are related to our past economic history and specifically to the events described earlier in this section. In this sub-section we summarize recent findings regarding control and capital structures of Chilean conglomerates and relate them, when possible, to some of the events previously discussed.

C.1 Control mechanisms

Lefort and Walker (2000) look at several dimensions of control in Chilean conglomerates. Chilean conglomerates use mostly simple pyramid structures to separate control from cash flow rights. Chilean Corporations Law prohibits cross-holdings and, although allowed, dual class shares are relatively rare in Chilean corporations. As of December 2001, only 8 percent of Chilean listed companies have dual shares. Table 1, extracted from Lefort and Walker (2000) indicates that Chilean groups use relatively simple pyramid structures where it is rare to find 4 layers of public corporations consolidated. However, the table clearly indicates that the number of layers used by groups has increased during the nineties. By 1990, only 13 percent of public corporations affiliated to groups were second or higher level. This figure increased to almost 35 percent by 1998. It is important to keep in mind, that although Chilean conglomerates are formed through relatively simple pyramid schemes of public companies, it is not always easy to ascertain the way the pyramid structures are controlled. The reason is that there are very few people among the largest shareholders. Controllers of these structures hold shares trough private holding companies with fantasy names that participate at all levels of the pyramid structure making very difficult to ascertain ultimate ownership to investors and regulators.[11] In spite of these problems, Chilean conglomerates are relatively simple. An interesting hypothesis is that the simplicity of these structures is due to legislation put in place in order to protect pension funds from expropriation. However, since tax laws in Chile allow tax credits on dividend payments, pyramid structures are not penalized by tax considerations. Another consideration regarding the control structures of Chilean conglomerates is that because Chilean banks are forbidden to hold company shares, groups are structured around holding companies instead of banks. That norm is a direct consequence of the debt crisis of 1982.

Because of the high degree of ownership concentration in Chilean companies, control is exercised, in practice, through board members elected directly or indirectly by the controlling groups. A survey of board practices at large listed Chilean companies indicates that only 55 percent of all board members are not directly related by family to the controllers or are not executives in the company or in other company owned by the same controller.[12] Moreover, Lefort and Walker (2000) show that, on average, each board member holds 1.6 seats where largest groups tend to centralize board positions in fewer people as compared to smaller groups. This evidence suggests that even board members elected with minority shareholder votes are exclusive of group firms. An exception are board members elected by pension funds in large corporations. Iglesias (2000) shows that 10 percent of board members in firms where pension funds own shares are elected with their votes. External mechanisms of control and corporate governance are rarely important in Chile. For instance, the efficiency increasing role of the market for corporate control in Chile is restricted by the very high level of

[8] Like Carter-Holt in the case of the Angelini group.

[9] For 1993, Paredes and Sánchez (1994) identify seventeen major groups, 10 of which are new and related with the second privatization round.

[10] Paredes and Sánchez (1994) interpret this evidence as significant mobility and no barriers to entry or exit of groups.

[11] The large difference between personal income and corporate tax rates explains the wide use of private holding companies.

[12] SpencerStuart and the Business School of the Pontificia Universidad Católica de Chile prepared the 2000 Board Index Report based on board practices used by 55 large listed Chilean companies.

ownership concentration of companies. In the vast majority of companies high ownership concentration eliminates the possibility of hostile takeovers. However, Since 1998 a large number of acquisitions have taken place in Chile. Lefort and Walker (2001) analyze 12 major acquisitions involving transfer of control between 1996 and 1999. They found that the average excess price for these 12 acquisitions was 70 percent, while the average control block purchased amounted to 40 percent of shares. On average, the cumulative abnormal return was approximately 5 percent, indicating that the average acquisition was perceived as value enhancing by the market.

C.2.Capital and ownership structures

Lefort and Walker (2000 and 2003) constructed consolidated balance sheets at the conglomerate level, for all non-financial public companies, in order to describe ownership and capital structure of Chilean economic groups. Some of the results are summarized in Table 2. As it was indicated above, groups are the predominant form of corporate structure in Chile. The table shows that companies affiliated to groups hold 90 percent of total non-financial, listed assets. Table 2 shows that conglomerates have increased their use of debt reaching almost 55% in 2002. The evidence presented in Table 3 also shows that, in general, controlling shareholders hold more equity than, in principle, is needed for control. The average controlling shareholder held 59 percent of the consolidated equity capital of the conglomerate in 2002. When interpreting this concentration figure, it is important to keep in mind, that a four layers pyramid structure can be controlled with less than 10% of consolidated equity. Some other interesting facts about capital structure in Chilean conglomerates are the following. Minority shareholders own around 40 percent of the equity controlled by Chilean groups with pension funds managers and ADRs representing 25 percent each of minority shareholders interest. Regarding debt composition, Lefort and Walker (2000) showed that conglomerates are able to get significantly more long-term and bond debt financing than non-affiliated firms.

5. Legal Background

Corporate structure is also affected by laws and regulations, which themselves many times respond to shocks or transcendental events in the political and economic environment, such as the ones outlined above.

A. General Framework

Table 5 shows the main laws and supervisory institutions that regulate financial activity in Chile. Among the laws, the most relevant are the Banking Law, the Security Markets Law and the Corporations Law. In addition, a series of other laws and regulations specify the rules of the game for institutional investors such as pension funds, mutual funds and foreign capital investment funds, and rule bankruptcy procedures among other things. Three main supervisory entities overlook different aspects of financial markets in Chile. The "Superintendencia de Valores y Seguros" (SVS) is in charge of supervising capital markets functioning and public company information disclosure practices. The "Superintendencia de Bancos e Instituciones Financieras" (SBIF) supervises the compliance of banking regulations. Finally, the "Superintendencia de Administradoras de Fondos de Pensiones" (SAFP) overlooks pension fund manager activities. The Central Bank also participates actively in the financial system regulatory and supervisory process, especially in issues regarding international transactions and foreign market participants.

Self regulation is almost inexistent in Chilean capital markets. Regulations are imposed by the appropriate authorities and supervised by governmental entities. Although, the Chilean legal system follows the tradition of French Civil Law, the Banking law, the Securities Market Law and the Corporations Law were written and reformed mimicking their homologues in the US. Since the Chilean Judiciary system does not have the flexibility of a judiciary under Common Law, some tension arises between the spirit of the Law and its application.[13] Moreover, there are still sharp differences in ownership concentration, market liquidity and law enforcement between Chile and the US. As indicated previously, the 1982-83 collapse of the financial system importantly shaped the evolution of the banking sector. As a consequence of the crisis a number of bailout measures were taken. After the crisis (in 1986) a comprehensive new banking law was dictated. In general terms, the new law included partial deposit insurance; requirements that financial investments be valued at market prices; credit risk provision requirements; and restrictions on currency and maturity mismatching. In addition, the new law introduced strict limitations on related lending and prohibited banks to keep shares in their portfolios, with a few minor exceptions.[14] The 1986 Banking Law is therefore partly responsible for the reduced importance of banks for corporate structure and governance in Chile. Bank credit was substituted off as a corporate source of funds and replaced partly by equity issues and to a lesser extent by corporate debt. Also, banks stopped being a central unit of economic groups, at least in organizational terms. At the end of 1997 new amendments were introduced to the 1986 Banking Law giving banks more flexibility and widening their business scope.[15] We can

[13] See Laporta, Lopez-de-Silanes, Shleifer and Vishny (1996).

[14] See Eyzaguirre and Lefort (1999).

[15] The most important changes were the following: procedures for new bank licenses were established; the

therefore guess that banks may become more important actors in capital markets development and corporate governance in Chile in the future.

The current institutional arrangements of Chilean capital markets developed starting in 1980 with the creation of the main supervisory entity, the "Superintendencia de Valores y Seguros". The Securities Market Law and the Corporations Law comprise the legal framework governing capital markets and the actions of listed companies in Chile. The main body of both the Corporations Law and the Securities Law was written in 1981. In response to the changing environment and as a consequence of the increasing financial integration and sophistication of Chilean capital markets, both laws were amended in 1989 and more deeply in 1994. Modifications consisted mainly in broadening the investment alternatives to institutional investors, and improving the regulation in matters such as conflict of interests and risk rating systems. More recently both laws were amended by the Law Nº 19,705 of year 2000 known as the OPA Law.[16] In 2001 the Securities Market Law was again amended.

B. Legal protection to investors and corporate governance in Chile

The recent interest for corporate governance practices around the world has also reached Chile. From the local point of view, the large and controversial control premiums, paid in several acquisitions of control stakes of flagship Chilean companies by foreign companies, have triggered legal reform and investors awareness of the problem. A standard framework to analyze corporate governance practices is provided by the OECD principles. These principles acknowledge not only the importance of legal protection, but also other mechanisms of corporate governance. The principles are structured in 5 categories that look at shareholders rights, board responsibilities and disclosure of information among others.[17] Although it is difficult to ascertain the extent of investor protection and of OECD principles compliance in Chile, Table 6 presents a tentative summary of the degree of compliance of the main OECD principles. This table was prepared based on the analysis of the legal framework, market participants opinions and the conglomerate structure results discussed previously in this paper. The table shows that a preliminary review to corporate governance practices in Chile indicates that 11 out of the 16 OECD principles reviewed are adequately complied in Chile while 5 are not. These results indicate a 69% of compliance. Among the principles unsatisfactory complied it is interesting to note some of the features of Chilean laws and conglomerate structure previously discussed. First, among the shareholder rights, Chilean practices do not assure the correct disclosure of capital and ownership structures. Secondly, boards do not tend to act in an independent manner from controlling shareholders. However, as I mentioned above, board members elected by institutional investors have played an important role in several cases of alleged violation of minority shareholders rights. These board members are prohibited by law to vote for a candidate related to the controller and, therefore, their votes tend to represent the minority interest. They are required to disclose their votes and candidates, and to inform the public of the reason behind those decisions. During the last few years, pension and investment fund managers have stand against corporate actions that could hurt the interest of the funds in the company, alerting the press and the authorities and initiating legal actions. However, the evidence suggests that the professional-independent board member is seldom present in Chilean corporations.

With respect to current corporate governance practices, Chilean laws have played an important role. The SVS has taking the lead in recent reforms promoting minority shareholders protection and more disclosure. In December of 2001, the Securities Market Law and the Corporations Law were amended. The amendment was known as the Corporate Governance Reform and introduced changes in five areas of the law. First, the market for control was regulated requiring that transactions involving changes of control were performed through a tender offer under a version of the equal opportunity rule. Second, the regulator increased the requirements on information and disclosure to listed corporations, specially in the case of transactions with related parties. Third, large listed corporations were required to form a board committee with a majority of board members non related to the controller. The functions of this committee were specified by law. Fourth, share repurchases were allowed in order to implement stock option packages as an incentive to executives. Fifth, equal treatment of foreign shareholders was guaranteed by law specially in matters regarding voting procedures. The amendments included a transitory rule that allowed firms to postpone the adoption of the new regulations regarding changes of control for three years. Most large companies have filled for the transitory rule. In summary, I have shown that family groups are a common form of corporate structure in Chile. Consistently with the hypothesis of Burkart,

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Basle recommendations on capital requirements were adopted; regulations on new domestic branches were simplified; international branches and operations were more easily allowed; and banks were allowed to hold shares of companies in related business such as stock brokers, investment and mutual fund managers, factoring and others.

[16] OPA stands as “oferta pública de adquisición de acciones” and refers to the tender offer requirement during takeovers.

[17] Lefort (2003) looks at corporate governance in Chile and discusses the compliance of several of these principles.

Panunzi and Shleifer (2002) it is possible that the presence of this type of corporate structure is due to the relatively low level of investor protection effectively set in place in the Chilean economy. In the rest of the paper I will test different hypotheses regarding conglomerates, family business and firm performance using a large sample of Chilean listed firms.

6. Empirical Procedure and Results

A. General Procedure

The main purpose of this section of the paper is to empirically evaluate the effect of family ownership on firm market valuation. The basic procedure consists in using a panel regression analysis to relate a measure of market valuation of the firm to indicators of agency problems, affiliation to conglomerates, family ownership and a series of controls at the firm and group level. The main indicator of market valuation will be the Tobin's q.[18]

For the right hand side variables I include:

Separation of voting from cash flow rights at the firm level. I will measure separation considering direct and indirect holdings of controllers and the existence of dual class shares. It is hypothesized that higher separation is associated with lower valuation.

Firm affiliation to a conglomerate. There are competing hypothesis with respect to affiliation (see Lefort and Walker, 2003). However, I hypothesize that after controlling for separation of rights, affiliation to a conglomerate in emerging economies is value enhancing due to internal capital markets, information sharing and other synergies.

Separation of voting from cash flow rights at the group level. It is a more complete measure of group affiliation. In addition to a standard dummy variable I use a measure of groups' cash flow rights constructed as the ratio between total consolidated equity capital in hands of the group's controllers and total consolidated assets of the conglomerate. By using the SVS definition of conglomerates I am assuming that for all relevant purposes the conglomerate is controlled by the group, family or dominant company. Therefore, a higher cash-flow rights ratio implies that the cash-flow/voting rights ratio of the conglomerate is also higher, and hence the incentives for minority shareholder expropriation are less severe. I hypothesize that higher separation is associated with lower valuation and payout.

Family ownership. I construct a dummy variable that takes the value of 1 whenever a firm is majority owned and effectively managed by a Chilean family.

The main control variables at the firm level are time dummies (or GDP grwth), 8 industry dummies, firm size, debt-equity ratio at market values, among others. The empirical model will, therefore, be of the type:

$$y_{it} = \alpha + \beta_1(sep_{it}) + \beta_2(fam_{it}) + \beta_3(daffil_{it}) + \beta_3(daffil_{it} \cdot fam_{it}) + \beta_3(daffil_{it} \cdot group_{it}) \\ + ZF_{it} \cdot \Gamma_1 + ZG_{it} \cdot \Gamma_2 + \varepsilon_{it}$$

Where:

y: a firm performance and value indicator such as Tobin's q.

sep: separation of cash from control rights at the firm level.

daffil: affiliation to a conglomerate dummy.

fam: family managed.

group_sep: separation of cash from control rights at the group level.

ZF: a set of control variables at the firm level, including Tobin's q in the investment equation, and time and industry dummies.

ZG: a set of control variables at the group level.

B. Data

In order to measure the impact of affiliation to family groups on economic performance I use Tobin's q calculated as the ratio between market and book value of company assets as a measure of firm's value. By using the SVS definition of conglomerates I am assuming that for all relevant purposes the conglomerate is controlled by the group, family or dominant company. Therefore, a higher cash-flow rights ratio implies that the cash-flow/voting rights ratio of the conglomerate is also higher, and hence the incentives for minority shareholder expropriation are less severe. For estimation purposes I have restricted the sample of public non-financial Chilean firms by removing from the sample all pure investment companies (usually forming part of a group) and very small companies that barely trade. This procedure meant that from the original sample of 246 firms I end up with 198 non-financial, non-investment companies.

To understand the two dimensions of affiliation in this study, consider that, at any point in time, an individual firm might be classified at any of four possible combinations of categories: (i) Family business and affiliated to a conglomerate; (ii) Family business and non-affiliated to a conglomerate; (iii) Non-family business and affiliated to a conglomerate; and (iv) Non-family business and non-affiliated to a conglomerate. Table 7 summarizes the distribution of data, as of 2002, in these four categories along the two dimensions. For instance, the table shows that by 2002 and considering 198 listed, non financial Chilean firms, a total of 158 (80%) were family business, while a total of 129 (65%) belonged to an economic group. Now, 105 (53% of the total) firms were both family business and belonged to a group (family group), while only 16 (8% of the total) were neither family or affiliated to a group. The table also shows that a majority (66%) of family businesses are also affiliated to a conglomerate, and that most firms

[18] See Lefort (2003) for a summary of the weaknesses and strengths of such a measure.

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affiliated to a conglomerate (80%) are family controlled. The distinction between family businesses and conglomerates in Chile may capture aspects other than simple the corporate structure. In fact, an interesting feature of conglomerates in Chile is that they tend to be constructed through similar pyramid structures regardless of the identity of the controller. Figures 1 and 2 show the structure of two major Chilean conglomerates: (i) the Luksic family, a traditional Chilean group; and (ii) ENDESA, controlled by the multinational ENDESA Spain.

C. Main Results

I want to answer the question of whether family ownership and control affects the market value of individual firms in Chile. As I already have mentioned, I use Tobin's q as a measure of market value and regress it against a set of firm level variables and some conglomerate level variables. The main control variables at the firm level are time dummies, 8 industry dummies, debt-equity ratios (at market values) and firm size. In terms of conglomerate level variables I use a group dummy, the cash-flow variable and a measure of the size of the conglomerate through the market value of total assets of public companies controlled by the group.

Table 8 presents the main results. I run four panel regression using pooled least squares estimation with heteroscedastic consistent standard errors.[19] Both the time dummies and the industry dummies were statistically significant individually and as a group in the four different specifications. Also, I find that larger firms have a higher Tobin's q indicating higher market valuation, while more indebted firms present lower market valuation after controlling for other factors. Both coefficients were statistically significant regardless of the econometric specification.

The first regression only includes a group affiliation dummy in addition to the already mentioned controls. The coefficient is not significantly different from zero. Regarding family business, the first regression includes a dummy variable taking the value of 1 whenever a firm on a specific date was both owned and managed by a Chilean family. The regression shows that companies managed by the controlling family present a lower market valuation. Their Tobin's q is 0.22 lower than a non-family firm. The third regression sees whether this result is robust to changes in the specification and the inclusion of other explanatory variables related to group affiliation. The regression shows that firms affiliated to a group have a slightly higher valuation and that the value of a firm importantly increases when the separation between cash flow and control rights decreases. Interestingly, the negative family coefficient is very robust to this new specification.

The last regression in Table 8 includes two different interaction effects. First, I included an interaction between affiliation to a group and separation between cash flow rights and control rights. The regression indicates that among firms affiliated to an economic group, lower separation increases value in an important way. Finally, firms affiliated to family groups present an important market discount, indicating that the market penalizes them with respect to groups controlled, for instance, by foreign companies.

Two important caveats have to be considered in analyzing these results. First, the regressions measure the marginal effect of group affiliation, family control and separation of cash flow from control rights on market valuation of traded shares. Hence, it does not measure firm performance. In other words, a firm affiliated to a conglomerate controlled by a family might do very well in terms of the controller interest, even if the market decides to penalize the value of shares traded in the stock market. Consistent with this view, Lefort and Walker (2001) found that shares privately acquired to gain control of Chilean traded firms between 1996 and 2000 were acquired at a 70% premium over market price. Of course, part of this premium, as well as, part of the discount obtained in these estimations could be due to the lack of liquidity of traded shares not captured by the size of firm assets.

The second consideration has to do with the potential endogeneity problems in this type of regressions as discussed by Klapper and Love (2003). Both separation of cash from control rights and family ownership could be endogenously determined by the firm's contracting environment. For instance, firms with more tangible assets or more growth opportunities would want to improve corporate governance mechanisms in order to raise external finance. In such a situation, they may decide to reduce separation of control and cash flow rights or transfer control to non-family foreign companies. However, these types of firms are also prone to present relatively higher market valuation, and thus the endogeneity problem. In this paper I assume that contracting differences among firms operating in the same country are minor, and that growth opportunities are adequately controlled by industry dummies and firm size.

7. Conclusions

When a founding or controlling family decides to hold on to control an appoint members of the family in key top executive positions they are balancing the pros and cons of that decision. On the one hand, having relatives in management mitigates the agency problem that the controlling family might face delegating their authority to an external manager. On the other hand, the family might be risking lower

[19] We did not use fixed or random effects estimation due to near singularity of the variance-covariance matrix.

performance if such a decision implies using relatively less talented managers.

The evidence provided in this paper indicates, that in the case of the highly concentrated Chilean companies, family management of a company is associated to a market discount. This evidence is consistent with the hypothesis of imperfect correlation of talent across generations. However, as I explained earlier in the paper, most Chilean groups have less than 30 years of existence and therefore, the succession problem is not likely to be very important in Chile.

An alternative hypothesis in order to explain the findings in this paper is that family business in Chile, specially those that function as a conglomerate, present worst corporate governance practices. The idea would be that although Chilean families might have successfully decreased agency costs imposed to them, they are still imposing a larger agency cost than non-family business to minority shareholders, and the market is penalizing them for that.

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Appendices

Table 1

Pyramid Schemes

	Corporations Level 1	Corporations Level 2	Corporations Level 3	Corporations Level 4
1990	93 87.7%	13 12.2%	0	0
1994	124 72.0%	45 26.6%	2 1.1%	1 0.5%
1998	96 67.1%	40 27.9%	5 3.5%	2 1.4%

Source: Lefort and Walker (2000)

Table 2
Importance of Chilean Conglomerates

Conglomerates	1990		1994		1998		2002	
	Assets (MMUS$)	Relative size (%)	Assets (MMUS$)	Relative size (%)	Assets (MMUS$)	Relative size (%)	Assets (MMUS$)	Relative size (%)
Largest	4,617	22.0	9,454	14.0	16,220	23.0	11,306	20.5
5 largest	9,264	44.0	34,018	51.0	37,704	54.0	26,304	47.6
10 largest	16,784	79.0	46,316	69.0	49,357	70.0	37,008	67.0
20 largest	18,784	88.0	54,259	81.0	57,570	82.0	46,655	84.5
All conglomerates	19,422	91.0	57,973	87.0	63,957	91.0	49,729	90.0
Non-affiliated	1,841	9.0	8,879	13.0	6,059	9.0	5,511	10.0
Total	21,263	100.0	66,852	100.0	70,017	100.0	55,241	100.0

Table 3
Capital Structure of Chilean Conglomerates

Conglomerates	1990		1994		1998		2002	
	Debt/ Assets (%)	Equity/ Assets (%)	Debt/ Assets (%)	Equity/ Assets (%)	Debt/ Assets (%)	Equity/ Assets (%)	Debt/ Assets (%)	Equity/ Assets (%)
Largest	27.3	72.7	14.0	86.0	53.2	46.8	58.1	41.9
5 largest	26.6	73.4	14.7	85.3	46.0	54.0	52.9	47.1
10 largest	26.6	73.4	17.9	82.1	44.9	55.1	55.1	44.9
20 largest	25.4	74.6	18.2	81.8	45.7	54.3	54.8	45.2
All conglomerates	25.9	74.1	18.5	81.5	46.7	53.3	54.7	45.3
Non-affiliated	22.5	77.5	11.1	88.9	42.7	57.3	43.4	56.6
Total	25.6	74.4	17.6	82.4	46.4	53.6	53.6	46.4

Table 4
Control Structure of Chilean Conglomerates

Conglomerates	1990		1994		1998		2002	
	Control/ Total eq. (%)	External / Control	Control/ Total eq. (%)	External / Control	Control/ Total eq. (%)	External / Control	Control/ Total eq. (%)	External / Control
Largest	55.4	1.5	63.7	0.8	18.4	10.6	49.1	3.9
5 largest	52.5	1.6	52.4	1.2	53.0	2.5	57.1	2.7
10 largest	52.9	1.6	53.2	1.3	56.0	2.2	60.2	2.7
20 largest	52.1	1.6	52.8	1.3	56.1	2.3	59.0	2.7
All conglomerates	52.3	1.6	53.6	1.3	57.0	2.3	58.8	2.8
Non-affiliated	85.3	0.5	98.0	0.1	93.5	0.9	-	-
Total	55.2	1.4	60.0	1.0	60.4	2.1	-	-

Table 5

Legal framework of Chilean capital markets

Super. de Bancos	Super. de Valores y Seguros			Super. de AFP
Banking law	Security markets law	Corporations law	Insurance laws	Pension fund laws
•Restrictions on Related lending •Unable to hold shares •Matching requirements •Credit risk provisions •Partial deposit insurance •Valuation at market prices	•Rights of shareholders stated and protected •Dual shares allowed with restrictions •Tender offer requirement when large premiums offered	•Information requirements and financial statements audited under GAAP •Shareholder meetings with cumulative and proxy voting •Board is governing body •Directors represent all shareholders	•Matching requirements •Strict reserve requirements •Otherwise quite flexible	•Limits on related party transactions •Limits by instrument type and issuer •Important role of Risk Rating Committee •Cannot buy underpriviledged shares

Table 6

Chilean compliance of OECD principles of corporate governance

I. The Rights of Shareholders		
1	Governance framework should protect shareholders' rights.	S
2	Right to participate and vote in shareholder meetings.	S
3	Capital and ownership structures should be disclosed.	U
4	Markets for corporate control should be allowed to function in an efficient and transparent manner.	S
5	Investors should consider the costs and benefits of exercising their voting rights	S

II. The Equitable Treatment of Shareholders		
1	Equitable treatment of all shareholders, including minority and foreign shareholders.	S
2	Insider trading and abusive self-dealing should be prohibited.	S

III. Role of Stakeholders in Corporate Governance		
1	The corporate governance framework should recognize the rights of stakeholders.	S
2	Stakeholders should have the opportunity to obtain effective redress for violation of their rights.	U
3	Performance-enhancement mechanisms for stakeholder participation.	U

IV: Disclosure and Transparency		
1	Timely and accurate disclosure is made on all material matters regarding the corporation.	U
2	Financial and non-financial information must be prepared, audited, and disclosed with high quality standards.	S
3	Independent auditors must provide an external and objective assurance about financial statements.	S

V. Responsibilities of the Board		
1	Strategic guidance of the company, the effective monitoring of management, and board's accountability to shareholders.	S
2	The board should treat all shareholders fairly.	S
3	The board should act independently from management and controlling shareholders.	U

Satisfactory: 11 (69%)
Unsatisfactory: 5 (31%)

Table 7
Family business and Group affiliation of Chilean listed companies (2002)

	Group affiliated			Non-group affiliated			Total
Family business	105 81%	53%	66%	53 77%	27%	34%	158 80%
Non-family business	24 19%	12%	60%	16 23%	8%	40%	40 20%
Total	129		65%	69		35%	198

Table 8

Panel Regressions
Tobin's q
Method: GLS (Cross Section Weights)
Total panel (unbalanced) observations: 711

Variable	Coefficient	p value	Coefficient	p value	Coefficient	p value	Coefficient	p value
C	-0.16	23.8%	0.04	76.5%	-0.19	19.5%	-0.29	6.2%
DGRUP?	-0.02	48.5%			0.06	2.5%	0.18	10.3%
FAM?			-0.22	0.0%	-0.22	0.0%	-0.05	51.2%
INVLV?					0.37	0.0%	0.18	13.2%
INVLV?*DGRUP?							0.29	4.0%
FAM?*DGRUP?							-0.26	0.7%
DA1?	-0.41	0.0%	-0.39	0.0%	-0.26	0.0%	-0.26	0.0%
LAIND?	0.11	0.0%	0.11	0.0%	0.11	0.0%	0.11	0.0%
D10?	-0.22	0.0%	-0.20	0.0%	-0.17	0.0%	-0.13	0.6%
D20?	-0.32	0.0%	-0.41	0.0%	-0.40	0.0%	-0.37	0.0%
D30?	0.09	9.8%	0.14	0.5%	0.12	3.2%	0.12	2.6%
D40?	0.15	0.2%	-0.02	64.5%	0.06	23.7%	0.03	60.8%
D50?	-0.26	0.0%	-0.27	0.0%	-0.23	0.0%	-0.23	0.0%
D60?	-0.45	0.0%	-0.45	0.0%	-0.44	0.0%	-0.43	0.0%
D70?	-0.22	0.0%	-0.21	0.0%	-0.19	0.0%	-0.20	0.0%
D1994?	0.07	14.9%	0.10	9.2%	0.17	0.5%	0.18	0.3%
D1996?	-0.24	0.0%	-0.28	0.0%	-0.23	0.0%	-0.22	0.0%
D1998?	-0.57	0.0%	-0.67	0.0%	-0.59	0.0%	-0.57	0.0%
D2000?	-0.58	0.0%	-0.64	0.0%	-0.57	0.0%	-0.56	0.0%
D2002?	-0.53	0.0%	-0.59	0.0%	-0.51	0.0%	-0.51	0.0%
Statistics								
R-squared	0.321		0.383		0.404		0.406	
Adjusted R-squared	0.308		0.370		0.390		0.389	
S.E. of regression	0.625		0.591		0.580		0.580	

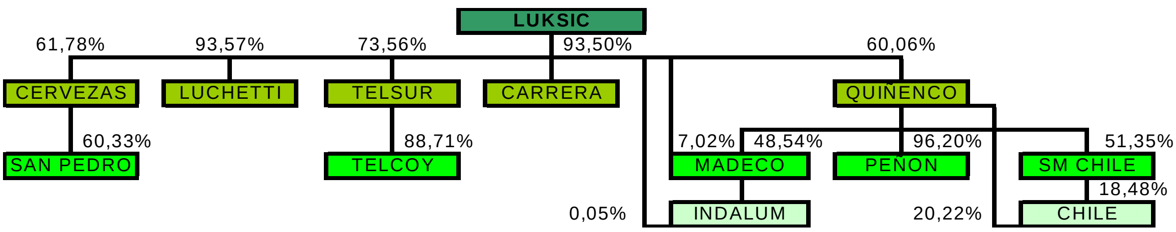

Figure 1. The Luksic Family Group

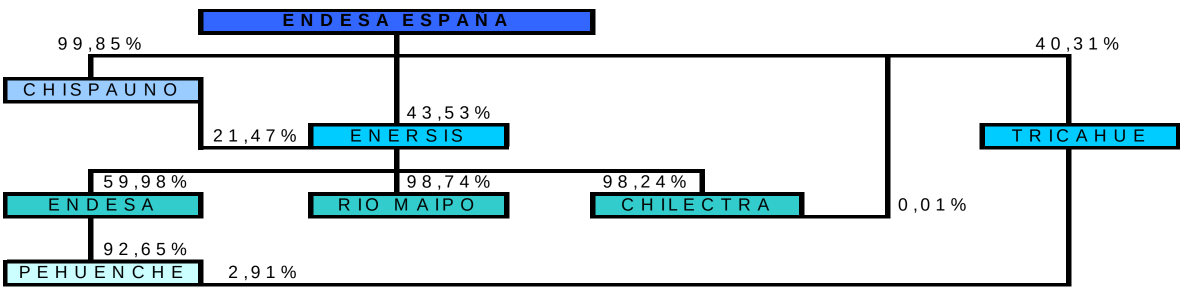

Figure 2. The ENDESA Chile Group