OWNERSHIP STRUCTURE AND PERFORMANCE: EVIDENCE FROM PORTUGAL

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Abstract

This paper provides new evidence on the impact of ownership over performance in small dimension markets. Analyzing the Portuguese firms we confirm the monitoring effect. Unlike previous studies, we also confirm the expropriation effect to low levels of ownership concentration. These results suggest that the free rider problem between the manager and the principal is significant in countries with small financial markets.

Keywords: Corporate Governance, Ownership Structure, Firm Performance, Portugal

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1. Introduction

Corporate governance issues have been recently highlighted either by researchers and investors. Topics as ownership structure and control are important to determine corporate performance, especially when other mechanisms to prevent both managers and major shareholders from expropriating the firm' wealth are weak (Westphal, 1999). Indeed, several studies have been carried out to measure the impact of ownership on performance. These studies are often headquartered in English speaking countries, special the U.S., and the U.K., and lately to the major European and Asian countries, neglecting other regions.

This study attempts to fill previous gaps in the empirical literature in corporate governance. Portugal, as a developed country with small dimension, with predominance of concentrate ownership, is an interesting research to expand international evidence, to compare with existent results to major countries and to extrapolate to countries with similar characteristics.

The main aims are three: 1) understand how ownership structure influences performance in Portugal; 2) verify if there are significant differences between market and accounting measures of performance; 3) determine which firm's characteristics are more relevant to explain the performance.

Relying on theoretical arguments we develop two models: one pointing the linear relationship between performance and ownership structure and other the nonlinearity of the relationship. Our results confirm the monitoring effect of the major shareholder. Using an accounting measure of performance, namely ROA, we find also the expropriation effect to low levels of ownership concentration, contrary to the results found to countries with large financial market. This suggests that to Portugal agency costs between the principal and the agent are more relevant than those between groups of investors.

The rest of the paper is organized as follows. Section 2 briefly reviews prior literature on this issue and outlines the hypotheses of this study. Section 3 describes the sample structure, the dataset and methodology. Section 4 presents the empirical results. Finally, the main conclusions are evident in section 6.

2. Theoretical Background

The debate of the importance of ownership structure on performance is not new. It is based on Jensen and Meckling (1976) who suggest that the separation of ownership and control lead to potential agency conflicts which in turn affect the firm performance. Managers can act differently from shareholder's interests, performing opportunistically. They can use their power and private information to satisfy their self-interests (Agrawal and Knoeber, 1996, Burkart *et al*., 1997).

The free-rider problems arise more often in case of dispersed ownership since individual shareholders ought no substantial portion of the firm to take effective decisions. Therefore concentration of ownership is a way to mitigate it as it reflects the influence of shareholders (Demsetz, 1983). The larger shareholder either maintains the management of the company, or has the power and the incentive to monitor manager's action in order to protect the firm and his-self interests (Shleifer and Vishny, 1986 and 1997). As a result of the monitoring effect, information asymmetries decrease, leading to better performance (Leech and Leahy, 1991). This positive and linear relationship between ownership structure and performance was found by Morck *et al.* (1988), Shleifer and Vishny (1986), Wruck (1988), Hermalin and Weissbach (1991), Galve and Salas (1993), Agrawal and Knoeber (1996), Morck *et al.* (2000), Gedajilovic and Shapiro (2002), Anderson and Reeb (2003), Barontini and Caprio (2006) and Martínez *et al*. (2007).

Likewise, our first hypothesis supports the existence of a linear relationship.

Hypothesis 1a: Ownership concentration increases performance.

Nevertheless, at higher levels of concentration the performance may decline due to expropriation. The major shareholder may try to satisfy his self-interests at the expense of the value maximizing approach. This leads to minorities' wealth expropriation (Hart, 1995, Shleifer and Vishny, 1997). Such divergence of interests between majority and minority shareholders is another source of agency costs (Faccio *et al.*, 2001, Vilallonga and Amit, 2008), which is more often when investors are poorly protected by law from expropriation.

A non linear relationship between ownership structure and performance was found by Claessens *et al*. (2002), Thomsen and Pedersen (2000), Anderson and Reeb (2003), and Miguel *et al*. (2004), to East Asia, Europe, E.U.A. and Spain.

This leads to our second hypothesis: the monitor effect prevails as ownership concentration increases, but at higher levels of concentration the expropriation effect overcomes.

Hypothesis 1b: Ownership concentration first increases performance, but at higher levels of ownership concentration the performance declines.

The magnitude of both types of agency costs is limited by how well the shareholders monitor managers and other investors (Ang *et al*., 2000). Therefore the relationship between ownership and performance can be regional affected.

For the U.K. for example, the agency costs between investors is more relevant. Leech and Leahy (1991) and Mudambi and Nicosia (1998) only found the expropriation effect to the U.K. firms. The concentration of ownership leads to worse performance as the market discipline has a weaker effect on monitoring managers.

3. Empirical Analysis

3.1 Sample Selection

The sample includes all companies of Euronext Lisbon from 2002 to 2008. On average we have 54 firms, ranging from a maximum of 61 in 2002 to a minimum of 47 in 2008.

Our research focuses on Portugal, a country excluded for the majority of studies about corporate governance, which pay greater attention to Anglo-Saxon countries and large financial markets. Portugal is a European country, with small dimension market and scarcely information about its firms. However, is important to analyze it, not only because of its importance to Europe, but also because the majority of the Portuguese firms have concentrated ownership differing from the main financial markets already investigated.

We start on the year of 2002 because it was when Portugal joined to Euronext. Before this date, there was more companies presented on the Portuguese financial market, but many of them were very illiquid.

3.2 Construction of the Dataset

Our first concern is ownership structure. We measure the presence of large shareholders – the proportion of shares held by the major (S1) and the three largest shareholders (S3), using CMVM's database (The Portuguese Securities Market Commission).

Ownership structure is the focus instead of insider ownership because it's the major problem in European companies. Large shareholders have both the power and the incentive to fire managers if they do not perform well. Moreover, the controlling shareholder is often involved in the firm's management.

The remain data was collected in DataStream database. Two performance measures are used: a market and an accounting measure, since there is no consensus about the optimal performance ratio. The proxy of Tobin's Q (Q) – market proxy of performance, is the market-to-book value (Thomsen and Pedersen, 2000, Demsetz and Villalonga, 2001, Claessens *et al*., 2002, Barontini and Caprio, 2006, Villalonga and Amit, 2006). The Return on Assets

ratio (ROA) – accounting measure of performance is the ratio of net income to total assets (Gedajlovic and Shapiro, 1998 and 2002, Thomsen and Pedersen, 2000, Demsetz and Villalonga, 2001, Anderson and Reeb, 2003, Barontini and Caprio, 2006).

We introduce five control variables into our analysis to control for firm characteristics. The firm' size (size) is the natural logarithm of the company's assets (Gedajlovic and Shapiro, 1998 and 2002, Himmelberg *et al*., 1999, Claessens *et al*., 2002, Anderson and Reeb, 2003, Miguel *et al*., 2004). It may have an ambiguous effect on performance; on one hand, large firms may have worse performance due to the difficulty to monitor managers, but on the other hand those firms can also have greater performance due to economies of scale, better knowledge of markets and the ability to hire more informed managers. The firm's age (age) is the difference between the firm's foundation and the year in analysis. According to Leech and Leahy (1991), Anderson and Reeb (2003), and others older firms can benefit from economies of scale, accumulated knowledge about the market, experience, and reputation, but can also be more inflexible and bureaucratic. Sales growth (SG) variable is the year-over-year sales (Gedajlovic and Shapiro, 1998 and 2002). A growing business may have more investment opportunities that can generate innovation and improve the firm's efficiency. Capital Intensity (CI) is measured by capital-to-sales ratio, and analyzes the importance of installed capital in the firm's technology (Demsetz and Lehn, 1985). Finally, debt intensity (debt) is the ratio of debt over total assets (Demsetz and Villalonga, 2001, Cui and Mak, 2002, Anderson and Reeb, 2003, Miguel *et al*., 2004). Firms with higher levels of debt tend to have better performance not only because of higher control from the debt holders, but also because managers have to pay the cost of capital.

3.3 Descriptive Statistics

Table 1 presents the principal descriptive statistics: mean, maximum, minimum and standard variation of the variables used in the estimation.

Descriptive statistics, namely mean, maximum, minimum and standard deviation for Q: Tobin's Q proxy, ROA: return on assets, S1: ownership' percentage of the major shareholder, S3: ownership' percentage of the three largest shareholders, age: firm age, size: logarithm of the firm' assets, SG: sales growth, CI: capital intensity, Debt: debt intensity.

It is important to point out that the major shareholder owns, on average, roughly half of the firm's ownership, and the three major shareholders own more than 60%. Therefore we confirm the predominance of ownership concentration in Portugal, already state by La Porta *et al.* (1999).

Attending to the firm's financial performance, measure by the proxy Q and ROA is on average positive, but some Portuguese firms present a negative performance. The differences are higher when we look for the ROA ratio, since the results range from a negative performance of 48.65 to a positive performance of 67.99. Comparing with the results obtained to the U.S. (Adams *et al.*, 2009) and the major European firms (Thomsen and Pedersen, 2000), we conclude that proxy Q is similar, but the accounting measure of performance is inferior to Portugal.

The Portuguese firms are older than the U.S. firms, but their size is on average higher (Adams *et al*., 2009). This situation was expected since the dimension of the Portuguese financial market is too small compared with the U.S. market and so there are less variations among the firms included in our sample, inferring the results.

The firm' sales growth is on average only 7% and in some cases is negative, confirming the recent market recession. It is important to point out that this growth is on average higher than those of the major European firms (Thomsen and Pedersen, 2000). The importance of the capital installed is quite different from firm to firm. Finally, on average the Portuguese companies use debt in order to grow and sustain their activity, but there are some exceptions.

The correlation matrix is exhibit on table 2.

Table 1. Descriptive Statistics

	S1	S3	Q	ROA	Age	Size	SG	CI	Debt
Mean	43.64	63.38	2.09	2.50	12.35	12.99	0.07	4.36	38.02
Maximum	94.79	99.99	37.19	67.99	20	18.36	4.67	39.45	167.78
Minimum	5.69	14.49	-4.42	-48.65	1	7.95	-0.83	0	0
Std. Dev.	22.96	20.27	3.15	8.78	4.98	2.18	0.34	5.14	20.72
N. Obs	360	360	360	360	360	360	360	360	360

Table 2. Correlation Coefficients

	S1	S3	Q	ROA	Age	Size	SG	CI	Debt
S1	1								
S3	0.829	1							
Q	-0.037	-0.064	1						
ROA	0.051	0.031	0.072	1					
Age	0.015	0.091	-0.116	-0.089	1				
Size	-0.095	-0.226	0.086	0.175	-0.227	1			
SG	-0.002	0.018	0.091	0.159	-0.053	0.070	1		
CI	0.214	0.131	0.085	0.207	-0.184	0.188	-0.016	1	
Debt	-0.119	-0.113	0.026	-0.194	0.065	0.241	-0.059	0.093	1

Correlation coefficient between Q: Tobin's Q proxy, ROA: return on assets, S1: ownership' percentage of the major shareholder, S3: ownership' percentage of the three largest shareholders, age: firm age, size: logarithm of the firm' assets, SG: sales growth, CI: capital intensity, Debt: debt intensity.

The correlation between the ownership percentage of the major and the three largest shareholders is high, but as these are alternative variables it is not significant. There is also a relevant correlation between the firm size and debt intensity, inferring that to grow the Portuguese companies have to look for external capital, mainly debt. None of the remaining variables is highly correlated, at least not to an extend which merits noting.

Contrary to our expectations, the alternative measures of the firm's performance: proxy Q and TOA are not correlated. Although the value to both variables is on average similar, the differences between the maximum and the minimum are huge. This situation means that the market perspective and the accounting values are quite different. Investors may highly valuate the firm's intangible assets and its future performance prospects, which are ignored by accounting measures.

3.4 Methodology

We use panel data to confirm if ownership structure influences performance. We also use fixed and random effects. Fixed effects may cause inferences in results when the variables are stable over the time, but random effects should only be used when strictly necessary (Adams *et al*., 2009). The Hausman test is also used to analyze which methodology is more accurate in our case (Himmelberg *et al*., 1999).

To validate hypothesis 1a we regress performance against ownership concentration.

$$Performance_{it} = c + \beta_1 S_{it} + \beta_2 Size_{it} + \beta_3 Age_{it} + \beta_4 SG_{it} + \beta_5 CI_{it} + \beta_6 Debt_{it} \quad \textbf{(1)}$$

Performance is measured using two proxies: Q and ROA. S represents ownership percentage of the major (S1) or the three largest shareholders (S3). The firm size (size), age (age), sales growth (SG), capital intensity (CI) and debt intensity (debt) are five control variables.

We introduce ownership concentration square in order to analyze the existence of a nonlinear relationship.

$$Performance_{it} = c + \beta_1 S_{it} + \beta_2 S_{it}^2 + \beta_3 Size_{it} + \beta_4 Age_{it} + \beta_5 SG_{it} + \beta_6 CI_{it} + \beta_7 Debt_{it} \quad \textbf{(1)}$$

This model presents one breakpoint which can be determined by differentiating performance with respect to ownership concentration. When the derivative equals to zero the breakpoint is $S_{it} = -\frac{\beta_1}{2\beta_2}$.

We also include industry dummies in order to measure the specific impact of industry.

4. Results

4.1 Univariate Analysis

Table 3 presents the medium value of the performance proxy: Q and ROA for the major (S1) and the three largest (S3) shareholders that have at least and more than 25%, 50% and 80% of the firm ownership. The idea is to compare if there are significant differences between owners with a small percentage of ownership and those with ownership concentration.

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Table 3. Differences in Performance

	S1		S3	
	ROA	Q	ROA	Q
S < 25%	3.608	2.578	0.587	1.937
S > 25%	2.227	1.943	2.632	2.133
Difference	-1.381	-0.636 **	2.044	0.196
S < 50%	1.801	2.204	2.005	2.456
S > 50%	3.312	2.048	2.686	2.017
Difference	1.511 *	-0.156	0.681	-0.439 **
S1 < 80%	2.587	2.098	2.455	2.219
S1 > 80%	1.782	2.352	2.655	1.806
Difference	-0.805	0.254	0.200	-0.413 *

Medium value (per year and type of group) of the performance proxy: Q and ROA for the major (S1) and the three largest (S3) shareholders that have at least and more than 25%, 50% and 80% of the firm ownership, and the differences between them.
*, **, *** Significant at the 10%, 5% and 1% levels, respectively.

We choose 3 breakpoints: 25%, 50% and 80%. For some researchers, the firm' owner must have at least 25% of its ownership to have effective control. 50% is the medium value of ownership and 80% represents a high control of the firm, more than 80% seems that the firm is not quoted one.

In a first analyze it seems that using the major or the three largest shareholders to measure the firm' ownership is not indifferent. The performance proxy used also cause variations in results.

The major shareholder must have at least 50% ownership in order to increase the firm ROA. There are not significant differences in performance using the breakpoints of 25% and 80% ownership, maybe due to small number of firms included when ownership is less than 25% or more than 80%. Using the proxy Q to measure the firm' performance it seems that when the firm owner owns more than 25% ownership the performance decrease. We cannot forget that while ROA is an accounting measure, the proxy Q shows the market perception. When a major shareholder controls the firm, investors may have afraid to acquire some ownership since the controller has more information about it – information asymmetry.

The firm performance measure by ROA increases when the percentage of ownership of the three largest shareholders increases. One more time, different results are found when we use the market measure. As we explain before, when the three largest shareholders detains more than 50% ownership (this percentage is smaller when we only consider on shareholder) the proxy Q decreases.

4.2 Multivariate Analysis

The results of the estimation of models 1 (1) and 2 (2) are present in tables 4 and 5. In the first table ownership concentration is the ownership of the major shareholder (S1), while in the second table is the ownership of the three largest shareholders (S3). Each table presents the results of the estimations using fixed and random effects, and for the two performance proxies: Q and ROA.

Analyzing table 4, the monitoring effect is confirmed when we use the proxy Q. These suggest that the market' investors predict higher performance as ownership concentration rises. This conclusion is different from the one found in the univariate analysis, which we were aware that is a limitative investigation. The estimation using fixed effects is more accurate. Moreover, none of the control variables are significant to explain performance, explaining the value of R^2. This insignificance suggest that investors may be more concerned with the firm' intangible assets and external factors which directly or indirectly affect the Portuguese market than the firm' characteristics. Analyzing the ROA ratio the conclusions are different. In this case, the estimation using random effects is more accurate. At low levels of ownership performance decreases and then rises after 56.25% ownership. These results differ from the ones obtained to the U.S. and the major European countries, suggesting that when the major shareholder owns a small percentage of ownership there are various shareholders in the firm with different interests, which make it easier to expropriate rents (Shleifer and Vishny, 1997). The degree of legal enforcement in Portugal is smaller than to the U.S. and some European countries (La Porta *et al*., 1998). Consequently investors are less protected, special from the expropriation of managers. We do not confirm the expropriation of minorities' wealth, implying that agency problems between the principal and the agent are more relevant in small financial markets. Moreover, the firm size, sales growth and capital intensity are important to explain performance in a positive way, while debt is relevant to explain it in a negative way. This means that higher firms with more backward and forward growth opportunities have more experience in generating higher results. Using debt in excess may increase the firm' probability of failure, which is translate in worse performance.

Table 4. Influence of the Major Shareholder in Performance

	Fixed Effects				Random Effects			
	Q		ROA		Q		ROA	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
C	2.525	2.917	-20.371	-22.766	1.925	-	-	0.165
S1	0.030 *	0.101 *	0.049	-0.381 **	0.010	0.008	0.004	-0.225 **
S1²	-	-0.001	-	0.004 ***	-	0.000	-	0.002 **
Age	0.103	0.114	0.227	0.160	0.031	0.031	0.088	0.100
Size	-0.277	-0.424	1.904	2.796 *	0.201	0.200	1.282 ***	1.254 ***
SG	0.414	0.423	1.687	1.636	0.506	0.505	2.753 **	2.810 **
CI	-0.024	-0.021	0.250 *	0.229 *	0.014	0.013	0.276 ***	0.256 **
Debt	0.174	0.016	-0.208 ***	-0.202 ***	0.006	0.007	-0.140 ***	-0.141
Industry	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R^2	1.13%	1.24%	11.43%	9.90%	12.53%	12.53%	16.06%	16.20%
H. Test	-	-	-	-	9.81	12.46 *	141.21 ***	15.08 **

Regression of performance (measure by proxy Q and ROA) and the ownership percentage of the major shareholder (S1), its square ($S1^2$), and some control variables (the firm' age, size, sales growth (SG), capital intensity (CI), and debt intensity (debt)). Dummy variables of industry are also included. We use fixed and random effects of the panel data analyzed. H. Test: chi^2 of Hausman test.
*, **, *** Significant at the 10%, 5% and 1% levels, respectively.

Table 5. Influence of the Three Largest Shareholders in Performance

	Fixed Effects				Random Effects			
	Q		ROA		Q		ROA	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
C	3.995	1.038	-17.741	-12.043	-0.641	-1.193	-5.213	-
S3	-0.000	-0.000	0.000	0.000	-0.000	-0.000	0.000	0.000
S3²	-	0.000 *	-	-0.001	-	0.000	-	-0.000
Age	0.132	0.094	0.277	0.350	0.031	0.029	0.088	0.093
Size	-0.309	-0.158	1.827	1.536	0.195	0.211	1.280 ***	1.267 ***
SG	0.480	0.415	1.794	1.921	0.533	0.505	2.763 **	2.779 **
CI	-0.026	-0.017	0.252 *	0.236 *	0.020	0.017	0.280 ***	0.283 ***
Debt	0.016	0.018	-0.213 ***	-0.217 ***	0.005	0.006	-0.141 ***	-0.143 ***
Industry	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R^2	1.18%	1.26%	11.34%	9.47%	12.74%	12.44%	16.14%	16.11%
H. Test	-	-	-	-	6.74	11.75 *	180.54 ***	675.25 **

Regression of performance (measure by proxy Q and ROA) and the ownership percentage of the three largest shareholders (S3), its square ($S3^2$), and some control variables (the firm' age, size, sales growth (SG), capital intensity (CI), and debt intensity (debt)). Dummy variables of industry are also included. We use fixed and random effects of the panel data analyzed. H. Test: chi^2 of Hausman test.
*, **, *** Significant at the 10%, 5% and 1% levels, respectively.

When we focus on the ownership of the three largest shareholders, the ownership structure is not a relevant variable to explain performance. The ownership value may increase, but the difference of interests between shareholders also rises, leading to insignificance impact on performance. The control variables included in the models have the same significance.

5. Summary and Conclusions

In this paper we provide new evidence on the relationship between performance and ownership structure of the Portuguese firms. We confirm the monitoring effect as Morck *et al.* (1988 and 2000), Anderson and Reeb (2003), Barontini and Caprio (2006), among others. Using proxy Q, a market measure of performance found a linear relationship. Using the ROA ratio, an accounting measure of performance, we found a nonlinear relationship but different from the one found to the largest financial markets. The free rider problem between the manager and the principal is significant in countries with small dimension, and so to low levels of ownership the performance decrease. Ownership concentration leads to higher performance.

Using the ownership of the three largest shareholders, ownership structure does not seem relevant to explain performance, since there are different interests about how to redistribute wealth.

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