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Ownership Structure, Acquisitions and Managerial Incentives

Both the theoretical and empirical literature assume that takeovers are less likely to occur when firms have large concentrated shareholders, e.g. family firms. Hence the disciplinary role of takeovers becomes irrelevant in incentivizing the management. We argue that this conjecture is false. Using a contracting model, we show that the existence of takeovers can work in favour of firms with controlling shareholders, amplifying the disciplinary effects relative to firms with dispersed shareholders. We further show how takeover threats interact with alternative governance structures, specifically, with monitoring and performance pay. While carrots (performance pay) and sticks (takeover threat) play substitute roles in incentive provision, the internal monitoring available to large shareholders is a substitute mechanism irrespective of the disciplinary effect of the market for corporate control.

Introduction

The nature of optimal corporate ownership has been a longstanding question in corporate governance literature. While large controlling shareholders can address managerial agency problems by monitoring management and alleviating the free-riding problem in takeovers (see e.g., Grossman and Hart, 1980; Demsetz and Lehn, 1985 and Burkart, Gromb and Panunzi, 1997), they may also expropriate other stakeholders by influencing management or deterring efficient takeovers to maintain their private control benefits (Stulz,1988). Empirical evidence about the effect of controlling shareholders, for example a founding family, on firm performance is also inconclusive (see Bertrand and Schoar (2006) who review the empirical studies on family ownership).

Amid the ongoing debate, we provide a new perspective on the role of controlling shareholders in the market disciplinary mechanism, and how it interacts with the firm's potential synergy characteristics and internal governance mechanisms. While the use of performance pay and internal monitoring are easily justified by the extant literature, the disciplinary effects of the market for corporate control are less obvious. In many countries, there are debates about the social cost of concentrated ownership structures, and some regulators (e.g., the European Commission) have been advocating in favour of breaking up concentrated ownership structures to facilitate the market for corporate control and its managerial disciplinary function.

In contrast to this standard view, our analysis shows that the managerial disciplinary mechanism of synergistic takeover can be strengthened by the presence of controlling shareholders. Furthermore, while the control premium required by controlling shareholders reduces the incidence of synergistic takeovers, the internal monitoring performed by these shareholders can complement the market disciplinary mechanism in high synergy potential firms. Overall, it is ambiguous whether dismantling a concentrated ownership structure would increase firm value and, in particular, in firms which provide high synergy potential to acquirers.

Our analysis suggests that more sophisticated policies for the market for corporate control may improve the social welfare more effectively.

Controlling Ownership and Managerial Agency Problem

The managerial agency problem is relevant even when considering takeovers of family firms. Founders hold 15% of the CEO positions, 30% are held by descendants while the absolute majority of approximately 55% are held by professional managers (Villalonga and Amit, 2006). Bidders that operate in the same industry, for example, will be able to observe the state of demand to assess the synergistic improvements. In contrast, family owners are likely to be less actively involved in firm operations, and less informed about the industry/market situation, which suggests their lack of operational expertise vis-a-vis managers.

In the presence of potential conflicts of interest between the management and shareholders, the market for corporate control serves a disciplining role. Then why does the private benefit of controlling shareholders, which increases the takeover premium, strengthen this market disciplinary mechanism?

We argue that, notwithstanding their negative effect on the incidence of synergistic takeovers, the controlling shareholders can strengthen the managerial disciplinary effect of a takeover in firms that offer acquirers large business synergies.

To answer the question intuitively, suppose that the manager has no anti-takeover defense. In this case, the manager can secure herself from takeover threats only by increasing the market value of the firm, and, therefore, the takeover threat can discipline the manager. In firms which offer high synergy potential to the acquirers, however, the manager may find it too costly to increase the market value enough to deter a synergistic takeover. The control premium required by controlling shareholders can complement the market disciplinary mechanism in this circumstance, and, specifically, reduce the profitability of synergistic takeovers and make the acquirers' bidding choice more sensitive to current market value. That is, it allows the managers of firms that offer high business synergies to reduce the takeover threat significantly by increasing the market value.

Technically, our model shows that the necessary and sufficient condition for the complementarity of ownership concentration and the market disciplinary mechanism is the log-convexity of the distribution function of potential business synergy. The market value increase from truthfully reporting the favorable state may, in itself, not significantly deter the takeover attempts for these firms since acquirers still find the business synergy more than offsets a high stock price. The control premium required by controlling shareholders makes truthful managerial reporting (and the corresponding market value enhancement) more effective in reducing the likelihood of a takeover. Specifically, the control premium increases the manager's opportunity cost of misreporting and, in turn, it reduces the information rent that shareholders forgo to the manager.

Interaction with Other Governance Mechanisms

The analysis also provides implications for the relationship between ownership structure and other governance mechanisms, such as managerial compensation and the monitoring function of controlling shareholders.

Given that the managerial agency problem cannot be fully eliminated by the takeover threat and managerial compensation, the monitoring function of controlling shareholders can complement the other two governance mechanisms in our setting.

We show that the disciplinary effect of synergistic takeovers reduces the information rent paid to the manager and, thus, it diminishes managerial incentive pay. This implies that managerial pay-performance sensitivity is negatively associated with ownership concentration in firms which offer high business synergies. Furthermore, our analysis also shows that, in high synergy potential firms in which controlling shareholders strengthen the market disciplinary mechanism, monitoring function of controlling shareholders can complement the market disciplinary mechanism, and, thus, ownership concentration increases the operating efficiency relative to firms with dispersed ownership.

Conclusion

Contrary to the common prior, the disciplinary effect of synergistic takeovers can be stronger in high synergy potential firms with controlling shareholders due to improvements in incentives for managerial self-selection. Specifically, the control premium encourages the manager to deter the takeover threat by increasing the current value of the firm. In this case, managerial entrenchment is consistent with improvements in shareholder value.

The disciplinary effect acts as a complement to the internal monitoring efforts of controlling shareholders in reducing the amount of incentive pay required to induce managerial truthfulness. In contrast, the control premium in firms with few synergies isolates the manager from the takeover threat, making incentive provision reliant on internal monitoring.

However, the disciplining effect of synergistic takeovers is not without its costs, making the overall value implications ambiguous. Incentive provision requires that shareholders accept relatively low bidding prices, by allowing takeovers with negative synergies. Furthermore, tailoring correct incentive pay requires a relatively high distortion to effort levels in times of economic downturns. While controlling ownership is able to mitigate these concerns, the existence of a control premium also reduces the incidence of socially desirable synergistic improvements in firm value.

Overall, policy makers should take care when considering implementation of constraints on the controlling states in order to facilitate the market for corporate control.

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