

# Family Values: Ownership Structure, Performance, and Capital Structure of Canadian Firms

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Theories of the relationship between concentrated ownership and firm performance predict positive, negative, or no statistically significant relationship, depending on the trade-offs between the alignment and entrenchment effects.<sup>1</sup> Likewise, empirical studies have produced mixed results, which may be due to two problems: one related to model specification, the other to model estimation. First, Demsetz and Villalonga (2001) and Claessens et al. (2002) argue that the relationship between family ownership and performance cannot be identified without disentangling ownership (claims against the cash flow of the firm) from control (the holding of voting rights at the Board level).<sup>2</sup> Studies that do not disentangle the alignment and entrenchment effects of ownership and control may conflate these effects, leading to inconclusive results.

A second explanation for the mixed results relates to unobserved firm heterogeneity: there may be systematic differences between firms with high and low ownership concentration. This generates an identification problem: while theory may suggest that causation runs from family ownership to performance, an alternative explanation is that causation is reversed.<sup>3</sup>

1. The alignment effect describes the positive incentive of ownership on corporate governance. As the ownership stake increases, there are greater incentives for controlling shareholders to monitor firm performance. The entrenchment effect describes the negative consequences of greater ownership by managers, since poorly performing firms are insulated from the possibility of a takeover. Managers may also pursue their private interests at the expense of other shareholders.
2. For the purpose of this study, we define control as holding 20 per cent or more of the firm's voting shares.
3. Demsetz and Lehn (1985) argue that efficient markets will lead to optimal ownership structures, since firms with inefficient ownership structures will fail to survive in the long run. Thus, the relationship between ownership and performance may be endogenous.

One limitation of existing international studies of ownership, performance, and capital structure is that most studies involve countries or regions with legal, regulatory, and market institutions that differ markedly from those of the United States, making it difficult to disentangle firm-level effects (such as the choice of capital structure, corporate governance, or management quality) from country-level effects. Canada provides an ideal setting for studying this question. Canada and the United States share a common legal ancestry, with Canadian corporate and securities laws adopted from American precedents (Buckley 1997). Both countries have the same English common-law legal system, require similar disclosure levels, and exhibit similar levels of shareholder protection (La Porta et al. 1998, 2000). At the same time, Canada features more concentrated corporate ownership than the United States and more prevalent use of dual-class shares and pyramidal structures that increase the risk of expropriation of minority shareholders (Attig 2005; Morck, Stangeland, and Yeung 2000).<sup>4</sup> A study of Canadian firms therefore provides a useful counterfactual assessment, since it features ownership structures resembling those of European or Asian firms in an institutional setting similar to that of the United States.

## Theory

Increased ownership by insiders or the presence of a large blockholder can sometimes lead to better performance. For example, greater equity ownership by insiders improves corporate

4. We use the term "dual-class shares" to refer to three categories of shares in Canada: non-voting shares, subordinate voting shares, and restricted voting shares. Pyramids occur when a blockholder controls an apex firm or holding company that has control stakes in a related group or chain of firms.

performance because the monetary incentives of the manager are better aligned with those of other shareholders, thereby mitigating the standard principal-agent problem. On the other hand, many studies that document the prevalence of family ownership around the world have expressed concerns that concentrated ownership, particularly in the presence of control-enhancing mechanisms, may have negative implications for firm performance: it may contribute to the entrenchment of poor managers, the expropriation of resources from minority shareholders, capital misallocation, and reduced or inefficient investment. A high prevalence of family ownership and control-enhancing mechanisms may also lead to financial inefficiency, since investors would be unable to invest in a properly diversified portfolio of widely held, and thus better-governed, firms (Morck, Stangeland, and Yeung 2000).<sup>5</sup> Moreover, the Organisation for Economic Co-Operation and Development (OECD 2007) notes that concentrated ownership has led to cases of shareholder expropriation and, subsequently, to large negative externalities for financial markets. Taken together, these issues have led some researchers to argue that the prevalence of family ownership can ultimately result in lower economic growth (Morck, Wolfenzon, and Yeung 2005).

This statement implies that if family ownership does indeed have such negative effects, then policy-makers may wish to consider implementing policies that discourage family ownership or, at the very least, discourage the use of control-enhancing mechanisms. As noted above, however, empirical evidence regarding the effects of concentrated ownership on firm performance is mixed. It is therefore necessary to further examine the relationship between family ownership and performance to determine whether a policy response is warranted.

## Methodology

Our study (King and Santor 2007) seeks to address these issues and makes four contributions to the literature. First, we collect annual data for

5. For instance, in many countries, a large proportion of firms may be closely held and/or have control-enhancing mechanisms. Investors who wish to (or may be required to) hold a market index must, de facto, invest in such firms despite the greater risk of expropriation of minority shareholders.

613 Canadian firms that were members of the TSX 300 and the S&P TSX Composite Index from 1998 to 2005 and identify the owner, the percentage control of votes, the percentage cash-flow stakes, and the use of dual-class shares or pyramidal structures in these firms. To our knowledge, this is the largest and most comprehensive database of Canadian ownership. Second, we distinguish between the effects of family ownership and control-enhancing mechanisms (specifically dual-class shares and pyramidal structures). Third, we examine the impact of ownership structure on both the market and accounting performance of our full sample, using as proxies Tobin's Q and return on assets (ROA), respectively.<sup>6</sup> Fourth, we test different theories relating ownership to capital structure. We are not aware of any other Canadian study that examines this issue.

To address the issues of endogeneity described above, we follow Claessens et al. (2002) Specifically, we use a random-effects specification to examine the effect of ownership on firm performance and capital structure:

$$y_{it} = \alpha + \beta'x_{it} + \delta OWN_{it} + \varepsilon_{it}, \quad (1)$$

where  $y_{it}$  is either Tobin's Q, ROA, or (for financial structure) leverage (measured as the ratio of total debt to total assets);  $x$  is firm characteristics, namely firm size, sales growth, industry Tobin's Q, ROA, financial leverage, firm age, membership in the composite index, and ratio of capital expenditures to sales (ROA and leverage are excluded when they are the dependent variable);  $OWN$  is a measure of ownership, whether the size of the control stake, dummy variables identifying owner type, the use of control-enhancing mechanisms, or the size of wedge between control stakes from cash-flow stakes;  $\varepsilon_{it}$  is the mean-zero residual adjusted for firm-specific heterogeneity.

## Results

The degree of family ownership and control-enhancing mechanisms exhibited by Canadian firms is high relative to that in the United States: over 32 per cent of the firms in the sample are family owned at the 20 per cent threshold, and 14 per cent have dual-class shares (compared

6. Tobin's Q is (total assets + market value of equity-book value of equity)/total assets.

with 20 per cent and 8 per cent, respectively, in the United States). We find that the market performance of free-standing, family-owned firms with a single-share class is similar to that of other firms (based on Tobin's Q ratios). We also find that these firms have superior accounting performance (based on ROA), and higher financial leverage (based on the ratio of debt to total assets). These results are consistent with the U.S. evidence in Anderson and Reeb (2003) and Villalonga and Amit (2006). In contrast, family-owned firms with dual-class shares have market valuations that are 17 per cent lower, on average, than those of other firms, despite having similar ROA and financial leverage. This valuation discount is consistent with evidence from U.S. and international studies that firms with a separation between cash-flow rights and control rights have lower valuations because they have a higher risk of expropriation of minority shareholders (Claessens et al. 2002; Villalonga and Amit 2006). This valuation discount is also robust when we control for Canadian firms that are cross-listed on U.S. exchanges. In summary, family ownership is not negative for performance per se: rather, it is the use of control-enhancing mechanisms that reduces a firm's valuation.

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