

Managing Ownership by Management

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Outline of the Paper

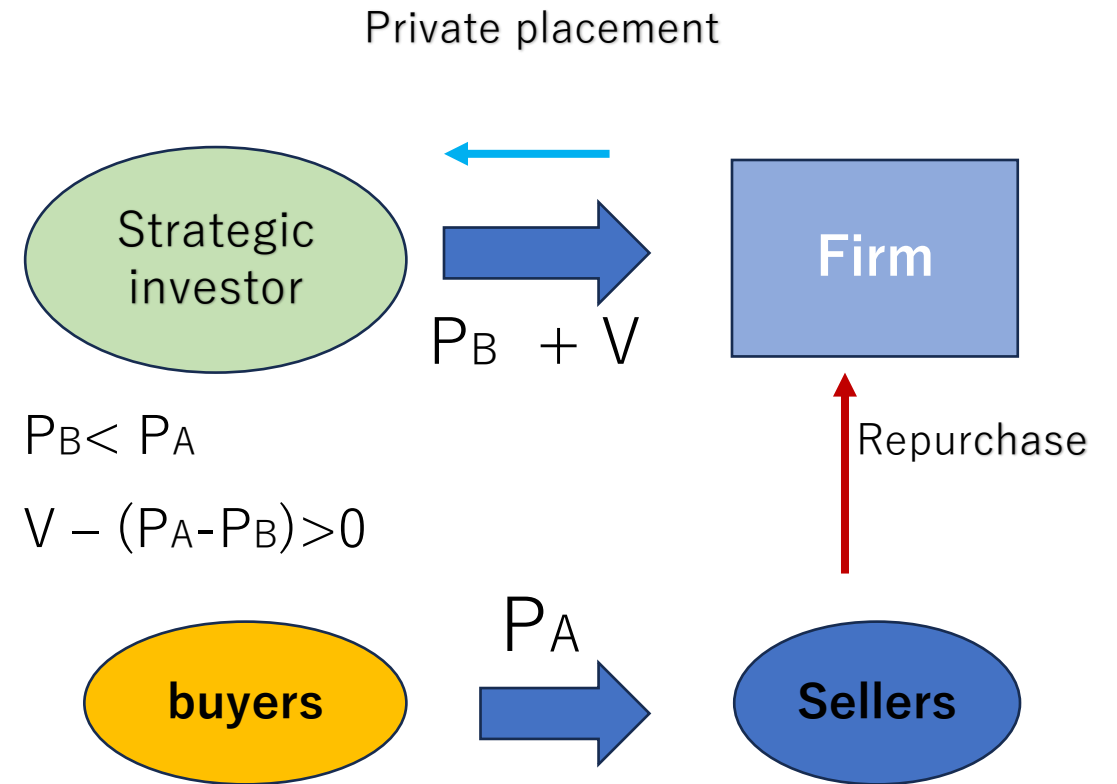
- Traditional description of the firm is: that as owners, shareholders have rights of appointment/removal of managers who manage the firm on their behalf
- Shareholders sell their ownership to others who attach greater value to these rights in **external markets for corporate control**
- This paper describes the **inverse process** by which managers manage the ownership of their companies(internal market for corporate control)
- **Main mechanism** is the repurchase program: managers repurchase controlling blocks of shares, hold them in Treasury and sell them to other purchasers, often, **new, strategic** partners.

Two competing views on the determination of ownership by management

- ❑ **An entrenchment view** : Barclay and Holderness (1989), Dyck and Zingales (2004)
 - exacerbate **managerial entrenchment** and impediments to managerial accountability to shareholders.
- ❑ **A commitment view of ownership**: Klein et al. (1978), and Aghion and Tirole (1994), Allen and Phillips (2000), Fee et al. (2006)
 - new block holders are expected to improve the performance of firms through being a **commitment device**.
- ❑ **Policy debates to the role of relational shareholding** : Criticism to the cross shareholding
 - Distinction between the former small reciprocal shareholding and the current intercorporate block holding.

Free-rider problem in the participation of strategic investors: The theory of the internal market for managing ownership

- **Starting points:** What is the market failure that justifies a role for managers managing ownership?
- A project that add a value by strategic investment
- Price is determined in outside market (P_A).
- The market price (P_A) is too high for strategic investors (P_B) to invest, resulting in **under-investment problem** analogous to **Grossman-Hart free rider problem** in takeovers.
- Firm (target) makes private placement to strategic investors with **discount** ($P_A - P_B$), mainly using treasury stock.
- Market positively responds to it.



The main proposition

- If there are **enough outside shareholders** with authority to discipline management, then management can be granted discretion to influence the ownership of their firm without reducing value of the firm.
- Managing ownership by management is no different from any other activity over which management has discretion that can exercise, for example, dual class shares, poison pill (see US business judgement rule; compare with UK).

Three Stages of Managing Ownership Program (2001-2018, TSE 1st section)

Stage I Repurchase

Public : Open market
Operation)

Private: block purchase
(ToSTNeTs: 49%)

II Cancel

Cancel (37%)

Treasury stocks

III Disposal

Public sales (28%)

Private placement (38%)

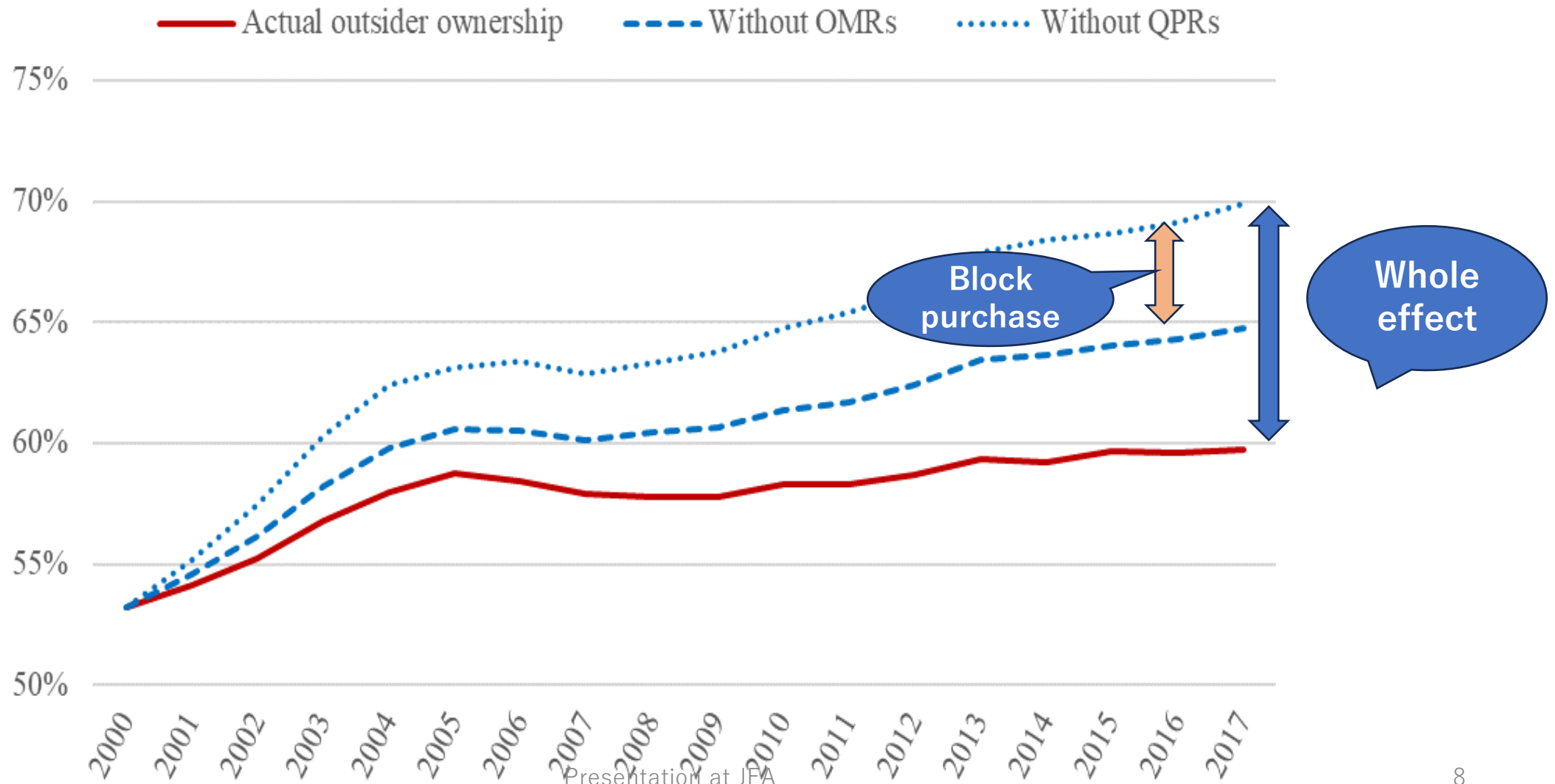
- **H1 Ownership**: The internal management of ownership results in a higher level of concentration of ownership of the firm than would have been observed had the repurchase of blocks not occurred.
- **H2 Disposal** : Treasury stock is placed as a block with a strategic purchaser, at a discount. Discount is a benefit to the buyer.
- **H3: Market Response** : positive share price reactions to the different stages of the internal management of ownership and the combined effect of repurchase of shares. CARs accrue to the seller.

The effect of repurchase program on ownership H1.

H1. The internal management of ownership results in a higher level of concentration.

- **Repurchases** through open market purchases
⇒ reduces outsider ownership
- **Block transaction** from insider through block purchase (ToSTNeT)
⇒ maintains insider ownership compared to the case that they sold them in open market
- The sale of treasury stock to insiders through **private placement**
⇒ Increases insider ownership

Contribution of Open-market and Private Block Repurchases



Stock Market Response to Repurchase Program: H2,H3

H2. Treasury stock is placed as a block with a strategic purchaser at a discount.

H3. Stock Market Response to Repurchase Program and Their Disposition

The Market Response to Repurchase Events (Block transfers): CAR -1, +3

Market response to each event

| | Events | CAR(-1,+3) |
|--------------|--------------------------|------------|
| Repurchase | open market transactions | 2.61*** |
| | Block:ToSTNeTs | 0.63*** |
| | TOBs | 0.84* |
| Cancellation | | 0.59*** |
| Disposal | Private placement | 1.52*** |
| | Multiple purchasers | 0.05 |
| | Strategic alliance | 2.85*** |
| | Public sales | -7.46*** |
| SEO | Authorized share | -7.05*** |

- Open market is positive, similar size to the US
- Block purchase (ToSTNeTs) is positive, but small.
- Private placement is positive
- Strategic alliance is the large.

Comparison with US

| | Japan | US |
|--------------------------------------|-------|-------|
| Repurchase (open market transaction) | 2.61 | 2.55 |
| Private Placement | 1.52 | 1.93 |
| SEO | -7.05 | -2.35 |

Market Reacts positively to strategic alliance

□ Main buyers :

- Majority are business corporations, in contrast to the US funds and financial institutions.

□ Revival of cross-shareholding: - Lower CAR

- Multiple purchaser/Cross shareholding: zero or **negative**

□ Strategic Alliance

- Frequent (**44%** of the private placement)
- Positive CAR:
2.85% in treasury or
3.3% in authorized shares

Who are the buyers ?

| | Treasury stock | Authorized shares |
|------------------------|----------------|-------------------|
| Total | 191 | 150 |
| Business corporation | 134 | 124 |
| Financial institutions | 15 | 3 |
| Funds | 10 | 13 |
| Individuals or family | 0 | 7 |
| Foundations | 4 | 0 |
| Incentive plans | 28 | 3 |

| | Private placements to business corporations (>=1.0%) | | | | | |
|---------------------------------------|--|--------------|----------------|-------------------|--------------|----------------|
| | Treasury stocks | | | Authorized shares | | |
| | Frequency | CAR (-1, +3) | CAR (-1, +120) | Frequency | CAR (-1, +3) | CAR (-1, +120) |
| Total | 127 | 1.52 *** | -1.47 | 124 | 1.53 | 0.57 |
| Single purchaser | 100 | 1.91 *** | 0.71 | 88 | 1.99 | 3.40 |
| Multiple purchasers | 27 | 0.05 | -9.54 * | 36 | 0.40 | -6.28 |
| New relationship | 62 | 2.39 *** | 1.58 | 43 | 3.26 | 5.41 |
| Existing shareholder | 35 | 1.49 * | -0.18 | 45 | 0.72 | 1.44 |
| Cross shareholding | 17 | 0.62 | -1.80 | 18 | 1.35 | -13.12 * |
| Operating loss | 8 | 4.69 | 10.42 | 20 | 7.18 ** | 19.26 * |
| Joint projects or strategic alliances | 57 | 2.85 *** | 6.52 | 54 | 3.29 * | 2.98 |

Substantial discount: H2

▣ Testing **Free Riding Problem**

Whether the price that a corporate buyer is willing to pay is lower than the market price?

- On average: -3%
- Strategic alliance /Joint projects: -3.67%

▣ Placement price is **below** market price, and the market response is positive

▣ The distribution of the wealth:

- Buyer gain/(Buyer gain +Seller gain):

Treasury 8.8%, Authorized share 31.3%

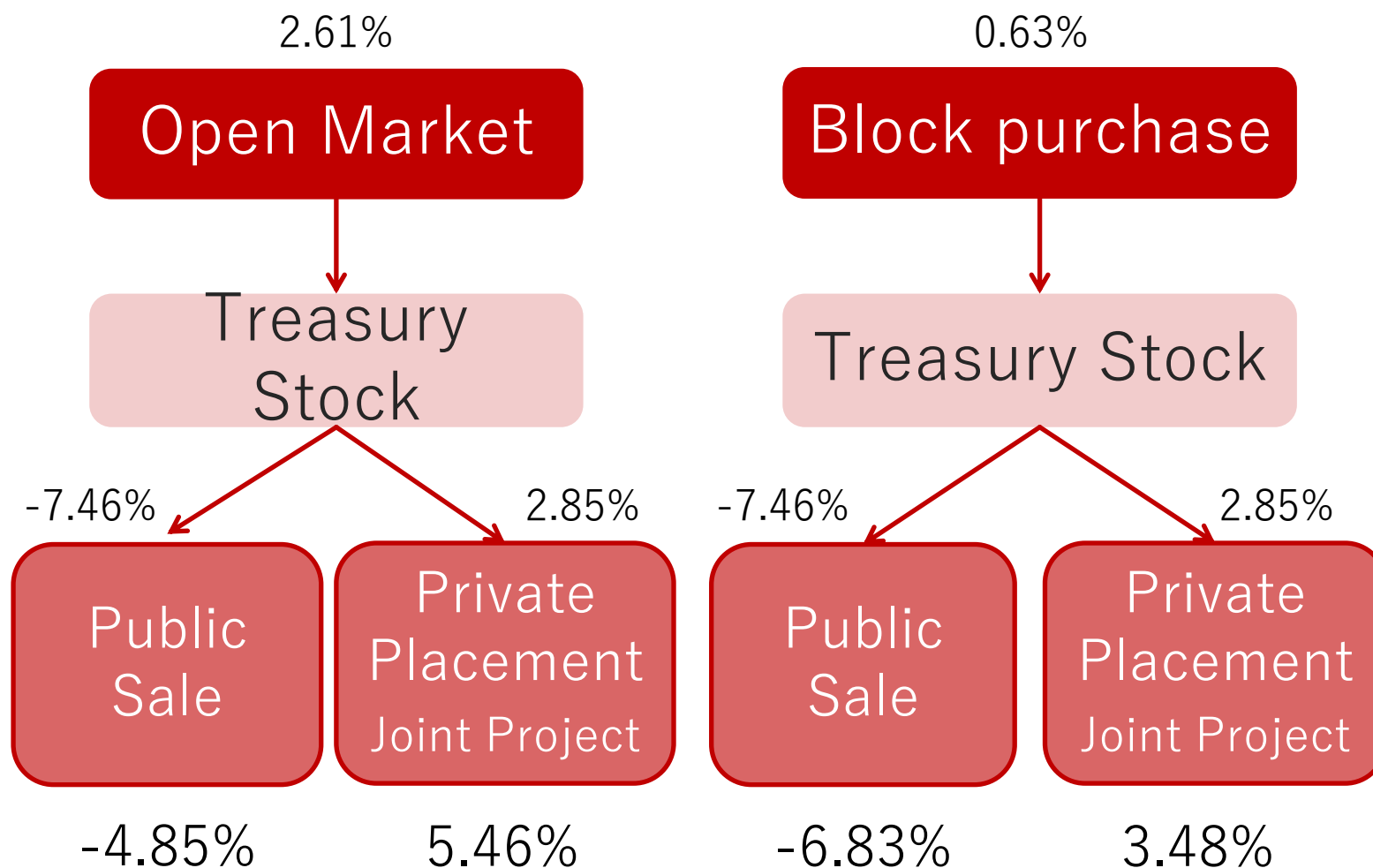
Buyer : substantial gain

Seller (existing shareholders): the rest (70-90%)

Premiums and discounts on issues by private placements (closing prices two day after the announcement)

| | Private placements to bussiness corporations ($\geq 1.0\%$) | |
|---------------------------------------|---|-------------------|
| | Treasury stocks | Authorized shares |
| Total | -2.82 *** | -5.82 ** |
| Single purchaser | -2.71 *** | -3.35 |
| Multiple purchasers | -3.23 *** | -12.03 *** |
| New relationship | -3.74 *** | -6.76 ** |
| Existing shareholder | -1.70 | -0.10 |
| Cross shareholding | -0.83 | -2.65 |
| Operating loss | -5.39 | -9.88 ** |
| Joint projects or strategic alliances | -3.67 *** | -4.77 ** |

Cumulative Abnormal Returns of Round Tripping: H3



- **The worst:** block purchase \Rightarrow to public sales = -6.83%
- **Frequent case 1:** Open market \Rightarrow Private placement : +5.5 %
- **Frequent case 2** Block purchase \Rightarrow Private placement : +3.5 %

Conclusion

- ❑ Combination of repurchases, treasury stock and private *placements* together comprise an internal market for corporate control, used to manage the ownership of Japanese firms.
 - ⇒ Repurchase is not financing vehicle like the US/UK, but **control vehicle** in Japan
- ❑ In contrast to traditional cross-shareholdings, what emerged in the 21st century are inter-corporate holdings that are **strategic** and on average **value enhancing**.
 - ⇒ To the policy debate, corporate ownership is not necessary value decreasing.
- ❑ Internal market is not substitute, but **complement** to the external market: It can be used to promote value enhancing outcomes, subject to external market discipline.
- ❑ Not confined to Japan. Observed in EU or Korea with dominant shareholders, or in the US (Wruck and Wu 2009). UK reconsidering attitudes to block ownership.
 - ⇒ Needs to examine whether managerial determination of ownership is a source of long-term value creation and better governance in other countries.