

Swedish Corporate Governance: What are the problems?

Martin Holmén
School of Business, Economics and Law
University of Gothenburg
martin.holmen@handels.gu.se

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Plan

1. Background
 - Theories and empirical results from the U.S.
2. Observations Sweden
3. Questions about Sweden
4. Empirical results Sweden
5. Interpretation of results
6. Summary and Conclusion

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Introduction

- Information asymmetry: one group of participants has better or more timely information than other groups
 - Typically, managers and controlling shareholders know more about the firm's prospect than outside/ minority investors
- Agency Theory: managers control and run the firm but the shareholders own it
 - Separation of ownership of control
 - Managers act as agents for the shareholders (principal)
 - Conflicting interest can lead to suboptimal resource allocation (agency costs)
 - Shirking, diversion of resources, different time horizon, different risk aversion

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Agency Theory and Finance

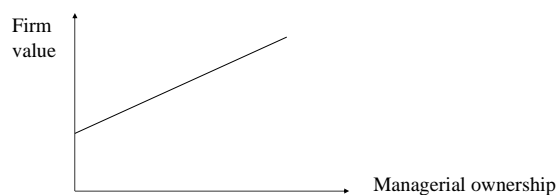
- Jensen and Meckling (1976) compare managers who owns 100% with a manager who sells a portion of firm equity (cash flow rights) to outsiders (e.g. 50%)
- A manager who owns less than 100% might have incentives to consume so called private benefits
 - e.g. not work as hard as he/ she should = firm value is reduced
 - He/ she consumes 100% of the benefits of this behavior
 - But he/ she only pays for 50% of the reduction in firm value.
- Problem increases with reduction in managerial ownership, and vice versa.

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Empirical implication

The agency model (Jensen and Meckling) suggest that firm value is increasing in managerial ownership.



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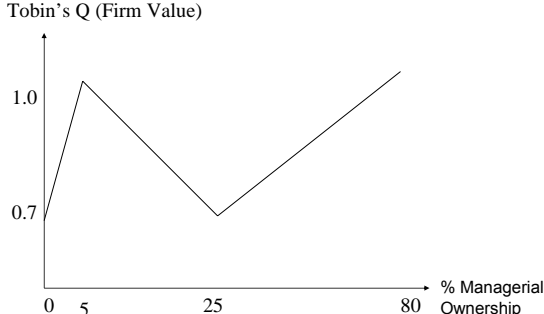
Only positive effects of managerial ownership?

- What happens if the manager is a major shareholder?
 - The largest shareholder in the firm?
- 1. Typically assumed that bad managers will be replaced by the shareholders
 - How do you replace the manager if he/ she is the largest shareholder?
- 2. Alternatively, the market for corporate control (takeover market) will replace bad managers
 - The firm is acquired and new shareholders replace the managers
 - Again, how do you acquire the manager's shares if he/ she does not want to sell?

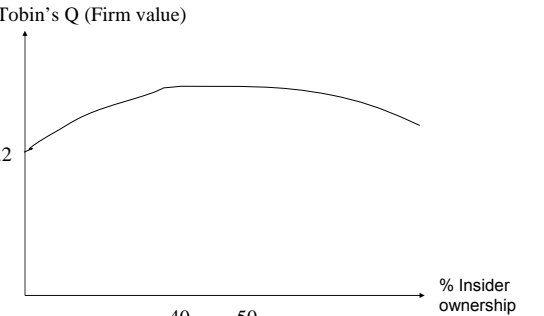
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7	Entrenchment
<ul style="list-style-type: none"> • A manager who is also a large shareholder is difficult (impossible?) to replace <ul style="list-style-type: none"> – Often called entrenchment (Stulz, 1988) • Thus, managerial ownership associated with <ul style="list-style-type: none"> – A positive incentive effect <ul style="list-style-type: none"> – Alignment of interest – A negative entrenchment effect <ul style="list-style-type: none"> – Manager wants to keep her job at an attractive salary • The net effect is an empirical question 	
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8	Morck, Shleifer, and Vishny (1988)
<ul style="list-style-type: none"> • Investigates the empirical relation between managerial ownership and firm market value <ul style="list-style-type: none"> – Market value proxy for firm performance <ul style="list-style-type: none"> – i.e. implicit assumption about efficient markets – Market value measured as average Tobin's q <div style="border: 1px solid black; padding: 5px; margin: 5px 0;"> $\text{Average Tobin's } q = \frac{\text{Firm's market value}}{\text{Replacement cost firm's plant and equipment}}$ </div> – A high Tobin's q supposed to measure valuable intangible assets <ul style="list-style-type: none"> – Goodwill, patents, monopoly power, or – <i>good managers</i> 	
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9	Results: Morck, Shleifer, and Vishny (1988)
<p style="text-align: center;">Tobin's Q (Firm Value)</p>  <p style="text-align: center;">Swedish Corporate Governance</p>	

10	Results: Morck, Shleifer, and Vishny (1988)
<p>Interpretation</p> <ul style="list-style-type: none"> – 0-5%: Positive alignment of interest effect (JM) – 5-25%: Negative entrenchment effect dominates <ul style="list-style-type: none"> – Managers have influence to guarantee their own employment at attractive salaries (Stulz) – 25%-80%: Positive alignment of interest effect dominates <ul style="list-style-type: none"> – Entrenchment effect does not increase with ownership, it is an indicator variable 	
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11	Results: McConnell and Servaes (1990)
<p style="text-align: center;">Tobin's Q (Firm value)</p>  <p style="text-align: center;">Swedish Corporate Governance</p>	

12	Results: McConnell and Servaes (1990)
<p>Interpretation</p> <ul style="list-style-type: none"> – Alignment of interest dominates up to 50% – At 50% hostile takeovers become impossible and firm value do not increase (or decrease) with higher levels of managerial ownership <ul style="list-style-type: none"> – Entrenchment effect 	
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13 **Sweden: Observation 1**

- Sweden #1 in terms of dual class shares
 - Shares with differentiated voting rights
 - "A and B shares": A = 10 votes, B = 1 vote
- #2 (after Belgium) in terms of pyramid structures
 - Extreme separation of voting rights from cash flow rights
- If no disadvantages the Swedish corporate governance model (with dual class shares and pyramids) would have been exported all over the world
 - All other models around the world have known disadvantages.

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14 **The General Approach to Design of Corporate Law**

"... dual-class shares can significantly promote the efficiency and development of individual firms as well as of the business sector in general...since it facilitates strong and stable ownership even in very large companies..."

...it also facilitates for original owners of growing firms to raise additional capital without losing control...

... There are no implications that the extensive usage of dual class shares has any any significant negative effects..."

From the preamble of the new Swedish Corporate Law (2001) written by Law scholars

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15 **Pyramid Structures**

The Owner controls Firm C-F (50% of the votes) but only owns 12.5% of the cash flow rights

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graph TD
  Owner -- 50% --> Holding[ Holding company ]
  Holding -- 50% --> FirmA[ Firm A ]
  Holding -- 50% --> FirmB[ Firm B ]
  FirmA -- 50% --> FirmC[ Firm C ]
  FirmA -- 50% --> FirmD[ Firm D ]
  FirmB -- 50% --> FirmE[ Firm E ]
  FirmB -- 50% --> FirmF[ Firm F ]
  
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16 **Pyramids with Dual Class Shares**

Still 50% of the votes in every layer but only 25% of the cash flow rights: The owner than has 6% of the cash flow rights in A and B but only 1,5% in C-F

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graph TD
  Owner -- "C=25%" --> Holding[ Holding Company ]
  Holding -- "C=25%" --> FirmA[ Firm A ]
  Holding -- "C=25%" --> FirmB[ Firm B ]
  FirmA -- "C=25%" --> FirmC[ Firm C ]
  FirmA -- "C=25%" --> FirmD[ Firm D ]
  FirmB -- "C=25%" --> FirmE[ Firm E ]
  FirmB -- "C=25%" --> FirmF[ Firm F ]
  
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17 **Private Benefits + Entrenchment?**

Typically in Sweden:

- The controlling owner holds very little cash flow rights
 - Incentives to consume private benefits (JM)
- But holds a large fraction of the voting rights
 - Entrenchment (Stulz)

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18 **Observation 2**

- Extreme separation of voting rights from cash flow rights does not appear to lead to extraction of pecuniary private benefits by the controlling owner
- Proxies for pecuniary private benefits among the lowest in the world
 - Price difference high voting and low voting shares small (Nenova, 2003)
 - Premium paid at negotiated control block transactions small (Dyck and Zingales, 2004)
 - Mergers and acquisitions within the pyramids do not appear to harm minority shareholders (Holmen and Knopf, 2004).
 - Contrary to e.g. Italy and South Korea

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19	Observation 3
<ul style="list-style-type: none"> • Sweden has some of the most powerful capitalists in the world (as % of GDP) <ul style="list-style-type: none"> – “Power spheres” controlled +50% of the stock market capitalization in 2000 – Generated 1/3 of GDP – Invested 1/4 of gross capital formation • And has been governed by Social democrats most of the time since the 1930s • Contradiction? 	
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20	Questions
<ol style="list-style-type: none"> 1. Is the separation of voting rights from cash flow rights associated with poor firm performance? 2. If so, what are the problems? 3. How has the "power spheres" and the Social democrats co-existed for 70 years? 	
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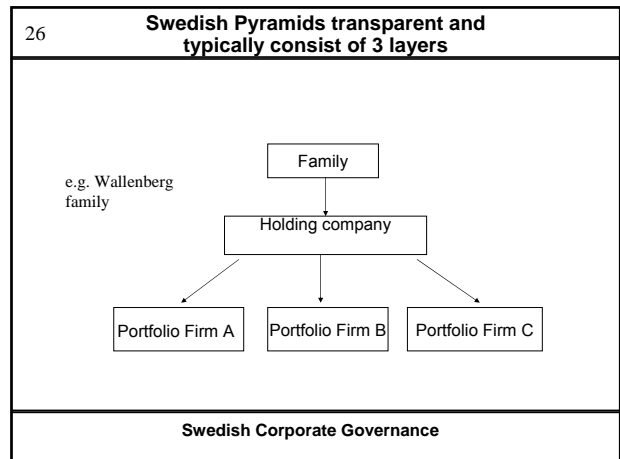
21	Cronqvist and Nilsson, 2003
<ul style="list-style-type: none"> • Disentangling the Incentive and Entrenchment Effects of Large Shareholdings in Sweden (following Claessens et al.'s study of East Asian countries) • Separate i) vote ownership and ii) difference between vote ownership and cash flow ownership <ul style="list-style-type: none"> • Note, no adjustment for pyramid structures • Focus on the largest shareholder – not necessarily manager <ul style="list-style-type: none"> • However, often involved in management • Or at least, appoints the CEO • Dependent variable: Market to book ratio of assets (proxy for Tobin's q) and ROA 	
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22	Cronqvist and Nilsson results
<ul style="list-style-type: none"> • Controlling Minority Shareholders <ul style="list-style-type: none"> – Large % of voting rights – Small % of cash flow rights • Associated with <ul style="list-style-type: none"> – Lower market values (Tobin's Q) and – Lower ROA • Captured by negative relation between % voting rights and Q and ROA, respectively. • Claessens et al find negative relation between <i>votes – cash flow rights</i> and Tobin's Q => more intuitive 	
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23	Cronqvist and Nilsson interpretation
<p>Dual class shares:</p> <ol style="list-style-type: none"> 1. Facilitate for controlling minority shareholders to hang on to control too long (entrenchment) <ul style="list-style-type: none"> – Large vote ownership with little capital investment 2. Lead to suboptimal investment and financing decisions (lower ROA) <p>=> No formal tests of these arguments</p>	
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24	Takeover probabilities and Takeover Premium?
<ol style="list-style-type: none"> 1. Formal statistical tests indeed suggest that family firms <ul style="list-style-type: none"> – A family is the controlling shareholder <p>with dual class shares are less likely to be taken over</p> <ul style="list-style-type: none"> – Holmen and Nivorozhkin, 2007 2. No indication that dual class shares lead to higher takeover premium (reduced myopia) <ul style="list-style-type: none"> – Once selection bias taken into account. – Holmen and Nivorozhkin, 2009 	
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25	Investment and Financing Behavior?
<ul style="list-style-type: none"> • Are there more to pyramids than "Tunneling" (Stealing) <ul style="list-style-type: none"> — Controlling owner at apex of pyramid "tunnels" resources from firms where he/ she has little cash flow rights to firms where he/ she has substantial cash flow rights <ul style="list-style-type: none"> - For example, when Saab is trying to sell Jet-fighters (JAS) to foreign countries - Other Wallenberg firms (e.g. Electrolux) promise to make substantial investments (negative NPV?) in that country - Wallenbergs have substantial cash flow rights in Saab and little cash flow rights in Electrolux • However, no indications of Tunneling within Swedish Pyramids (following Bertrand et al's (2002) methodology) 	
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27	Holding company has tax-status as Closed End Investment Fund (CEIF)
<ol style="list-style-type: none"> 1. Dividends received by the CEIF tax exempt if distributed to the CEIF's shareholders <ul style="list-style-type: none"> — Families have limited incentives to let portfolio firms pay large dividends – diluted before they reach the family 2. CEIF's realized capital gains tax exempt if reinvested <ul style="list-style-type: none"> — CEIF has incentives to reinvest realized capital gains – not pay them as dividends 	
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28	Specific Questions
<p>Holmen and Hogfeldt (2009) focus on the Swedish pyramids' financing and investment behavior.</p> <ol style="list-style-type: none"> 1. How efficient are the investment policies of portfolio firms when the tax legislator provides incentives to reinvest profits – instead of paying dividends? 2. How efficient is the active portfolio management of the CEIF when investing realized capital gains? 	
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29	Two Data-sets
<ol style="list-style-type: none"> 1. Panel of roughly the 150 largest non-financial firms <ul style="list-style-type: none"> • 1985-2000 • Around 1276 firm year observations • Almost half of the firms controlled by a CEIF at some point 2. Panel of 13 CEIFs – have CEIF tax status <ul style="list-style-type: none"> • 1985-2000 • 125 fund year observations 	
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30	Main Results 1:
<ul style="list-style-type: none"> • Pyramiding discounted (Lower Tobin's Q) both at the portfolio firm level and at the CEIF level <ul style="list-style-type: none"> — CEIF discount not a function of discounts on portfolio firms – based on market values • Separation of voting rights from cash flow right by pyramids and dual class shares associated with lower portfolio firm market value <ul style="list-style-type: none"> — Remember, Cronqvist and Nilsson did not adjust for pyramids • Portfolio (Pyramid) firm discounts related to high retention ratios <ul style="list-style-type: none"> — When <i>Retention ratio</i> interacted with <i>Pyramid dummy</i> the <i>Pyramid Dummy</i> per se becomes insignificant 	
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31	Main Results 2a:
<ul style="list-style-type: none"> • Portfolio firms have higher Investment – Cash Flow sensitivity than non-pyramid firms <ul style="list-style-type: none"> — No indications of capital constraints • Portfolio firms' investments to a larger extent determined by historical profits (retained earnings), not future growth opportunities <ul style="list-style-type: none"> • Compared to "stand alone firms" 	
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32	Main Results 2b:
<ul style="list-style-type: none"> • Portfolio firms have marginal $q < 1$ when investing retained earnings <ul style="list-style-type: none"> — Not when investing new debt or new external equity • Formally: New financing by i) new debt, ii) seasoned equity offers: SEO (external equity), and iii) retained earnings (internal equity) • Regression Analysis: $\text{Change market value of firm} = a \cdot \text{New Debt} + b \cdot \text{SEO} + c \cdot \text{Retained Earnings}$ • Null Hypothesis: $a = b = c = 1$ 	
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33	Main Results 2b:
<ul style="list-style-type: none"> • For firms outside the pyramids (stand alone firms) <ul style="list-style-type: none"> • $a = b = c = 1$ • Not significantly different from 1 • For portfolio firms (pyramid firms) <ul style="list-style-type: none"> • $a = b = 1$ • $c < 1$ <ul style="list-style-type: none"> • Significantly smaller than 1 <p>=> Interpretation: Overinvestment of retained earnings (tax incentives not to pay dividends since diluted at CEIF level)</p>	
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34	Main Results 3:
<p>Average CEIF discount roughly 25%</p> <ul style="list-style-type: none"> — Twice as high as on US and UK CEIFs <p>Dividends Received roughly equal to Dividends Paid</p> <ul style="list-style-type: none"> — Realized capital gains not paid as dividends — Tax incentives <p>CEIF Discount increases with <i>Retention Ratio</i></p>	
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35	Main Results 4:
<ul style="list-style-type: none"> • Compare CEIF's actual active portfolio with passive buy and hold each year • Median return on CEIF's active portfolio 1.2% lower than on passive portfolio <ul style="list-style-type: none"> — 0.7% lower after controlling for Administrative Expenses and Compensation to fund managers. <p>=> Preliminary Interpretation: Overinvestment of realized capital gains (tax exempt if reinvested)</p>	
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36	Main Results 4 continued:
<ul style="list-style-type: none"> • Neoclassical explanation of Closed End Investment Funds discount (Ross, 2002) <ul style="list-style-type: none"> • Discount must be the difference between owning the CEIF's portfolio directly or indirectly through the CEIF • Discount function of the extra costs (K) for the investor • Assume dividends (DIV) and K constant fraction of portfolio value in perpetuity, then $\text{Discount} = K / (\text{DIV} + K)$ 	
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37	Main Results 4 continued:
<ul style="list-style-type: none"> Ross' model generates discounts that reasonably well explains average discounts on US (8%) and UK (12%) CEIFs (Gemmeil and Thomas, 2002) $\text{Discount} = 0.5\% / (3.5\% + 0.5\%) = 12.5\%$ In Sweden, on average DIV = 2.9% and K=0.4% $\text{Discount} = 0.4\% / (2.9\% + 0.4\%) = 12.1\%$ But actual average discount = 25%? 	
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38	Main Results 4 continued:
<p>In Ross model return on investments = required rate of return</p> <p>If investment decisions influenced by control motives</p> <ul style="list-style-type: none"> return on investments < required rate of return We argue that this is captured by the CEIF's active portfolio being 1.2% lower than on passive portfolio 0.7% lower after controlling for Administrative Expenses and Compensation (K in Ross' model). We call this Leakage (L) Assume that half of expenses (K) are "extra" due to indirect ownership through CEIF, i.e. $(1.2\% - 0.7\%) / 2 = 0.25\%$ $\text{Discount} = (K + L) / (DIV + K + L) =$ $(0.25\% + 0.7\%) / (2.9\% + 0.25\% + 0.7\%) = 25\%$ 	
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39	Interpretation
<ul style="list-style-type: none"> With high transparency, first rate accounting and juridical standards, well-developed financial system, and high level of tax compliance, there might be other problems with pyramiding than corporate stealing <ul style="list-style-type: none"> However, stealing cannot be ruled out Our Suspect: Inefficient Investment 	
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40	Overinvestment Hypothesis
<ul style="list-style-type: none"> Highly levered control over other shareholders' capital (retained earnings) tends to make portfolio firms overcapitalized and leads to overinvestment Reinforced by tax system Costs and potential losses borne disproportionately by non-controlling shareholders <p>"...managers can lose for shareholders as much as, or more than, they can steal from them..." (Roe, 2002)</p>	
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41	Overinvestment Hypothesis: Simple Example
<ul style="list-style-type: none"> A portfolio firm has excess funds after making all NPV>0 investment <ul style="list-style-type: none"> Dividends? Or reinvest at NPV= -1%? Dividends will be diluted at CEIF level and will pass through CEIF due to taxes <ul style="list-style-type: none"> Families cash flow rights in portfolio firms on average < 5% Non-pecuniary private benefits > 0.05% of the investment will give the controlling family incentives to reinvest <p>=> Small private benefits can lead to suboptimal investment decisions</p>	
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42	Hypothesis: Private benefits in Sweden?
<ol style="list-style-type: none"> Swedish capitalists (power spheres) need political support to legitimize extensive use of dual class shares and pyramids <ul style="list-style-type: none"> The Wallenbergs and the Social democrats jointly lobbied in Brussels against proposed EU ban on dual class shares Social democrats (in power 1932 to 2006 except 9 years) support capitalists levered control as long as pyramidal firms make investments that stabilize employment over the business cycle. <ul style="list-style-type: none"> i.e. Swedish capitalists "cannot" fire employees in downturn Social democrats closely affiliated with powerful labor unions. 	
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43	Hypothesis: Private benefits in Sweden?
<p>⇒ the private benefits associated with overinvestment consist of</p> <ul style="list-style-type: none"> — political influence — smooth relations with the powerful labor unions — political support for the extreme separation of voting rights from cash flow rights <p>⇒ CEIF controlled firms overinvest in order to keep employment stable</p> <ul style="list-style-type: none"> • How do you test this? 	
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44	Volatility number of employees
<ul style="list-style-type: none"> • Not necessarily the number of employees • Instead the variation in the number of employees <p>⇒ The volatility of the number of employees significantly lower in the CEIF controlled firms compared to “stand alone firms”.</p> <ul style="list-style-type: none"> • Further research on this issue would be interesting <ul style="list-style-type: none"> • More direct tests needed 	
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45	Cronqvist, Heyman, Nilsson, Svaleryd, and Vlachos, JF 2009
<ul style="list-style-type: none"> • Instead of variance in number of employees: • Focus on entrenched CEOs <ul style="list-style-type: none"> — Voting control — Separation voting rights from cash flow rights • Results: Entrenched CEOs pay their workers more <ul style="list-style-type: none"> • Power “game” between i) managers, ii) shareholders, and iii) workers 	
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46	Swedish pyramids: Implications I
<ul style="list-style-type: none"> • Main problem not inefficient internal capital markets <ul style="list-style-type: none"> — Direct capital transfers not legally allowed (only dividend upward and SEOs downward) since stand alone entities — Indirect capital transfers possible (tunneling) but higher transaction costs and regulated by tax system and accounting standards • Major problem: Too much capital retained and locked into pyramid firms. <ul style="list-style-type: none"> • May lead to overinvestment. • Investment determined by historical profits not by future growth opportunities. 	
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47	Marcus Wallenberg: CEO Investor (CEIF)
<p><i>“...Investor’s general view is that a strong financial position should primarily be used to finance profitable investments in our own portfolio...The turbulent conditions of recent years have demonstrated the importance of a strong balance sheet to weather periods with weak demand and illiquid markets. Only when these factors have been taken into account should portfolio firms consider the possibility to pay out any remaining overcapitalization to the shareholders...”</i></p> <p>(Quarterly report, 2004)</p>	
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48	Swedish pyramids: Implications II
<p>Too much earnings retained in mature industries</p> <p>→ Pyramids may hamper efficiency of overall capital allocation</p> <p>Even if capital allocated efficiently within the pyramid</p> <ul style="list-style-type: none"> — Almeida and Wolfenzon (2004) on conglomerates — Too few firms are founded – too few grow fast <p>Not necessarily a problem for shareholders per se</p> <ul style="list-style-type: none"> — Compensated by discounts on fund and on portfolio firms — But socially costly — Tunneling or overinvestment – Does it matter? <ul style="list-style-type: none"> — Corporate law does not seek to control bad decision making (Roe, 2002) — No pyramids in the US but not illegal – instead inter-corporate dividend tax 	
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49	Motivation for inter-corporate dividend tax
<p><i>"Close financial control, through interlocking spheres of influence over channels of investment, and through the use of financial devices like holding companies and strategic minority interests, creates close control of the business policies of enterprises which masquerade as independent units....Private enterprise is ceasing to be free enterprise and is becoming a cluster of private collectivism; masking itself as a system of free enterprise after the American model, it is in fact becoming a concealed cartel system after the European model....And industrial empire building, unfortunately, has evolved into banker control of industry. We oppose that." Roosevelt, AER 1942</i></p>	
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50	Summary empirical results I
<ul style="list-style-type: none"> • The Swedish corporate governance model combines Pyramiding with Dual Class Shares <ul style="list-style-type: none"> – Multiplicative separation (increasing over time) – Combines free cash flow problem with insulation from market for corporate control (Jensen, 1986; Stulz, 1988) • <u>Result 1:</u> Separation associated with discounts <ul style="list-style-type: none"> • Once pyramid structures adjusted for • Separation less than theoretical limit since costly (discounts) • However, "no" indications of tunneling 	
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51	Summary empirical results II
<ul style="list-style-type: none"> • <u>Result 2:</u> Discounts function of <ul style="list-style-type: none"> • Entrenchment: Controlling owners hang on to control too long • Overinvestment: the tax legislator provides incentives to reinvest profits – instead of paying dividends 	
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52	Summary empirical results III
<p><u>Result 3:</u> Private benefits associated with control and overinvestment</p> <ul style="list-style-type: none"> – Political influence – Smooth relations with powerful labor unions – Political support for the extreme separation of voting rights from cash flow rights <p>The "power spheres"/ capitalists have survived since the 1930s because of (not despite of) a Social Democratic government (Hogfeldt, 2004).</p>	
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53	Conclusion: Swedish Corporate Governance Model
<ul style="list-style-type: none"> • Balance of interest between labor and capital different in Sweden (Scandinavia?) than in Anglo-Saxon countries <ul style="list-style-type: none"> => Agency problems different • Stem more from controlling shareholders' incentives to meet interests from other stakeholders (labor market) <ul style="list-style-type: none"> • than extraction of pecuniary private benefits • However, minority shareholders demand compensation for such agency costs as well <ul style="list-style-type: none"> • for example, investors do not want to take responsibility for Swedish employment <p>=> Discounts</p>	
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