CORPORATE BLOCKHOLDINGS AND FIRM PERFORMANCE: THEORY DEVELOPMENT

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ABSTRACT

Longitudinal studies indicate that toehold target economic performance persistently declines on average when interfirm equity investments are held for more than three years, while corporate blockholders economic performance temporarily improves. This study would extend extant research by simultaneously examining the economic performance of both equity-associated firms using a multivariate approach.

INTRODUCTION

As business enterprise adapts to a global economy, interfirm collaboration has become a common means of sharing risks and exchanging scarce resources in order to gain competitive advantage vis a vis other firms (Chi, 1994; Smith, Carroll, & Ashford, 1995). When collaboration such as technology partnerships (Doz, 1988) and strategic alliances occurs between large and small firms, it is common for the larger firm to buy and hold a block of stock in the smaller firm (the toehold target).

Blockholdings constituting five to fifty percent of the toehold target's stock are interesting because they are difficult to justify theoretically since any monitoring costs that blockholders incur reduce their return (Schleifer & Vishny, 1986). For example, if all shareholders realize identical returns per share, then large, active shareholders that incur monitoring costs earn a lower rate of return on their total investment than small, passive shareholders that do not. Moreover, empirical event study research indicates that when corporate blockholdings representing between 5 and 50 percent of a toehold-target's common stock are held for more than three years, average toehold target performance persistently declines (Mikkelson & Ruback, 1985). The negative toehold target performance trend associated with long-term corporate blockholdings is counterintuitive because corporate managers are rewarded for increasing stockholder wealth, an impetus for restructuring investment and business portfolios.

Because it is implausible that corporations would hold onto large, poorly performing stock investments unless the apparent continuing economic losses associated with the toehold target's underperformance and monitoring costs are compensated for in some way, in this paper, hypotheses predicting three possibilities for such compensation are theoretically developed. The authors posit that average long-term economic performance measures mask performance trends associated with control and trade variables that plausibly describe the relationship between the firms. The next section develops theory to support the hypotheses and describes a multivariate model that could simultaneously test contingency hypotheses related to both corporate blockholder and toehold target abnormal returns.

THEORY DEVELOPMENT

First, between equity-linked firms, returns may vary with the source of the blockholding because private placement contracts may work to favor or constrain a corporate blockholder in ways that do not affect blockholders that acquire shares from third parties.

Second, returns may vary among shareholders in relation to the extent of their control and monitoring effort. In other words, a large ownership interest may enable a corporation to more successfully compete for private benefits that could enhance its return (Barclay & Holderness, 1989).

Third, between equity-linked firms, returns may vary with the form of the trade relationship because there may be more opportunities to share transaction cost savings or transfer resources between vertically or horizontally related firms than between unrelated firms. An effective corporate strategy is one able to provide an economic return to investors. For a single firm, an effective corporate strategy is one that aligns the strengths and weaknesses of the firm with the opportunities, threats, and resources in its environment. When one firm is partially owned by another, we posit the toehold target may be a source of tangible or intangible resources and the effects on the economic performance of both firms may be predicted in part by variables describing the toehold target's ownership structure and their trade relationship.

We assume that all parties to capital investment transactions are economically rational. We envisage that the level of corporate blockholder ownership and insider ownership of a toehold target, the source of a corporate blockholder's shares, and the trade relationship between a corporate blockholder and its toehold target are contextual circumstances that affect the probability of a hostile change in control of the toehold target. We anticipate that the probability of a hostile change in control of the toehold target affects the simultaneous decisions of managers in corporate blockholder and toehold target corporations. If the contextual circumstances we describe influence firm manager decisions and firm manager decisions influence firm performance, then the contextual circumstances may influence firm performance.

Corporate Blockholder Ownership

Agency theory posits that manager (agent) and stockholder (principal) interests may diverge to the extent that the managers do not own the firm (Jensen & Meckling, 1976). Accordingly, managers may choose an opportunistic decision alternative (such as consuming perquisites) that would reduce the performance of the firm if that alternative optimizes their interests. A corporation's board of directors is responsible for monitoring manager decisions and proscribing manager decisions that may be detrimental to stockholder interests. However, monitoring effort is costly, and only insiders (directors and corporate officers), blockholders, and potential acquirers are likely to have sufficient motivation to monitor manager decisions closely.

Motivation to maintain a blockholding is posited to be enhanced when a blockholder is in position to privately extract rents in addition to dividends and capital appreciation. For example, a blockholder with the financial capacity to effect a takeover may encourage toehold target managers to reduce their employment risk by permitting an ongoing private transfer of technology to the blockholder. A private transfer of technology (or any other economic resource) from a toehold target to a blockholder would enhance the blockholder's return on its stock and monitoring investment, but ultimately reduce the return available to other toehold target shareholders, including the target's managers and its directors.

It is implausible that toehold target managers would be willing to allow their firm's performance to be reduced if their jobs are secure because firm performance is usually associated with their compensation. However, personal circumstances such as low levels of target stock ownership may make the expected value of the ongoing transfer alternative optimal *for them*. The dozens of targeted shareholder repurchase transactions that were ratified by directors in the 1980s is evidence that such circumstances sometimes exist.

The ability of a corporate blockholder to extract rent from a toehold target may depend on whether the former has "effective" control of the latter. Effective control is associated with 20 to 50 percent ownership in financial reporting guidelines (equity method) and tax law (dividend exclusion deductions change at a level of 20 percent ownership). Accordingly, we posit that a corporate blockholder that controls from 5 to 20 percent (a "low" minority level) of the toehold target's common stock is less able to extract rents from a toehold target than a corporate blockholder that controls from 20 to 50 percent (a "high" level in the minority range) of a toehold target's common stock.

> *Hypothesis 1. All else equal, the abnormal return means that occur when corporate blockholders hold from 5 to 20 percent of their toehold target's common stock will significantly differ from the abnormal return means that occur when corporate blockholders hold from 20 to 50 percent of their toehold target's common stock.*

Because private rent payments may reduce returns available to other toehold target investors, the extent of interests held by toehold target insiders or other blockholders may affect the ability of a long-term corporate blockholder to privately extract rents. A discussion of the motivation of each of these parties to monitor the toehold target managers follows.

Toehold Target Insider Ownership

Corporate officers and directors are considered to be "insiders" by the Securities and Exchange Commission. The sum of their holdings is the extent of insider ownership. Extensive insider ownership tends to align the interest of managers and passive shareholders because perquisite consumption becomes less attractive to managers when they personally absorb a large fraction of perquisite costs (Jensen & Meckling, 1976).

Similar logic suggests that extensive insider ownership also makes perquisite payments to others (i.e., blockholders) unattractive. We posit that unless there are contractual ties that limit the discretion of toehold target managers, a corporate blockholder's influence ultimately rests in its ability to threaten the tenure of toehold target managers through a proxy fight or hostile takeover. A proxy fight threat is less credible when extensive insider ownership directly provides many shareholder votes friendly to incumbent managers.

Although a high level of insider ownership serves to inhibit the ability of corporate blockholders to extract rent from toehold targets, corporate blockholders may passively benefit from large investments in toehold targets that have a high level of insider ownership. Stulz (1988) argues that the premium that a hostile bidder must pay to gain control of a target firm increases as the percentage of equity owned by managers increases, but the probability that the takeover will be completed decreases. When insiders own a small percentage of the shares outstanding, it is more likely that a hostile takeover will be completed at a premium that is less than the maximum the bidder is willing to pay. As the percentage of managerial equity ownership increases, the probability of a completed hostile takeover, for any given premium, declines so at 50 % managerial ownership, the probability of a hostile takeover is zero.

This logic lead McConnell and Servaes (1990) to expect a curvilinear relation between the value of a firm and the percentage of its shares owned by insiders. To test this theory, McConnell and Servaes plotted the relationship between Tobin's Q and the percentage of insider ownership using two large cross-sectional samples reflecting 1976 and 1986 data. Both plots resembled gradual mound-shaped curvilinear relationships. In 1976, the inflection point when Tobin's Q was highest occurred when insider ownership was 49.4 percent. In 1986, the inflection point when Tobin's Q was highest occurred when insider ownership was 37.6 percent.

Following McConnell and Servaes (1990), we also anticipate that a high level of firm value is associated with a high level of firm performance, and that high levels of firm performance will be associated with high levels of insider ownership. However, we define a "high level of toehold target insider ownership" to be from 35 percent to 50 percent and define "low toehold target insider ownership" to be any lower percentage. If high toehold target insider ownership is associated with high toehold target performance, then all shareholders, including corporate blockholders, may be expected to benefit from a level of insider ownership in that range. Thus, we predict that there are two situations when a corporate blockholder may expect to obtain a high return from a stock investment in a toehold target: (i) when the corporate blockholder's level of ownership is high, or (ii) when toehold target insiders' level of ownership is high.

Hypothesis 2. All else equal, the abnormal return means that occur when toehold target insiders own from 35 to 50 percent of the toehold target's common stock will significantly differ from the abnormal return means that occur when toehold target insiders own less than 35 percent of the toehold target's common stock.

Other Blockholders

The ability of a blockholder to appropriate rent from a toehold target may depend on the extent of ownership held by "other blockholders" defined here as 5 percent or greater common stockholders who are neither toehold target insiders nor corporate blockholders that retained their investment more than three years. Predicting the motivation of these more transitory blockholders is problematic because they could act independently or in cooperation with either the long-term corporate blockholder or the toehold target insiders. Accordingly, we merely control for low (from 5 to 20 percent) or high (from 35 to 50 percent) levels of other blockholder ownership.

Vertical Trade Relationship

Arm's length trade relationships may be inefficient for a production network that requires specific investments. For example, specific investments undertaken by a pipeline company and a refinery may expose each party to the possibility of opportunistic behavior by the other. Dyer and Ouchi (1993: 56) note "...[P]artner-specific investments create substantial buyer and supplier switching costs and, once made, make the two parties highly interdependent. This interdependence can create potential contracting problems if the parties do not completely trust each other". Minority-level equity investment is a governance mechanism that can be expected to reduce the benefits of opportunistic behavior because, if the toehold target performs badly, both sets of stockholders suffer loss. Accordingly, when long-term contracts are bonded by long-term minority-level equity investments, firms may be more likely to mutually benefit.

> *Hypothesis 3. The abnormal return means that are associated with a vertical trade relationship between the corporate blockholder and toehold target firms will significantly differ from the abnormal return means that occur when a trade relationship is not vertical.*

Horizontal Trade Relationship

Firms often link with firms in the same industry to share risk in technology development or to extend global reach. For example, France's Groupe Bull acquired 19.9 percent of Packard Bell Electronics in order to access its U.S. retail distribution system. If the corporate blockholder distributes the additional products through the distribution channels of the toehold target and the products are directed toward a different set of customer needs, then this relationship may be mutually beneficial. Alternately, if the corporate blockholder invests in a competitor in order to hinder it, learn from it, or extract cash from it through management contracts (Ipsen, 1991), the intended outcome may be win/lose. Because both win/win and win/lose outcomes are plausible, we make only an exploratory prediction that performance means will differ if a horizontal trade relationship with a direct competitor exists.

> *Hypothesis 4. The abnormal return means that are associated with a horizontal trade relationship between the firms will significantly differ from the abnormal return means that occur when a trade relationship is not horizontal.*

Corporations may also invest in firms that are neither customers nor suppliers nor direct competitors to access the toehold targets' proprietary technologies. Although firms may not be linked at the time of the purchase of a block of stock, the transfer of technology could signal future competition within an industry.

Proposed Multivariate Model

Each of the variables described above plausibly could affect the performance of the corporate blockholder or its toehold target. Together, they variables constitute a multivariate model of the predicted relationships between the dependent performance variables and the independent variables. The model includes a link is drawn between toehold target performance and corporate blockholder performance dependent variables to reflect the transfer of pro rata financial returns (dividends and capital appreciation) and anticipated private benefits to the corporate blockholder.

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