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Are European listed corporations short-termist?

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A recent study prepared for the EU Commission[1] has found that EU listed companies are increasingly focused on the short-term financial benefits of shareholders rather than long-term interests and sustainable value creation. It argues that the root causes of this behaviour lie within the regulatory framework and market practices (i.e. lack of a strategic perspective on sustainability, short-term focus of board-member mandates, and remuneration), and alleges that this will both undermine the investment capacity of firms and harm cash balances.

In response to this alleged short-termism, the EU Commission is considering a series of measures such as: harmonising directors' duties and board composition; incentivising long-term shareholding; reducing quarterly reporting; and broadening reporting targets. The study's conclusions were strongly contested by top academics in both the EU and the US (see for example Roe *et al*., 2020) – a challenge that was at first not matched by the relevant European professional associations.

Attempts to harmonise company law concerned with corporate governance are as old as the single market, but have not advanced much given that governance is closely linked to the national system of property rights and the general economic order in every member state. Unlike securities law, differences in company law (e.g. directors' liability, shares and voting rights) are not seen as a barrier to the single market, except for anti-takeover defence structures. The latter was the subject of several proposals, with the Takeover Bids Directive finally agreed in 2003, although this was far from perfect.

More recently, the EU adopted the Shareholder Rights Directive (SRD II), which facilitates cross-border voting, and requires both more disclosure of directors' pay and the adoption of guidelines on non-financial reporting. This time the debate is driven by the sustainability

[1] EC (2020), "Study on directors' duties and sustainable corporate governance", 29 July, European Commission.

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question and the possible adaptations to the EU regulatory framework on company law and corporate governance.[2]

The study

In order to assess the origins of short-termism in corporate governance, the study examines the amount of net corporate funds used for pay-outs to shareholders (e.g. dividends, shares buybacks). It then compares this to the amount used to create value over the life cycle of the firm (e.g. investment in infrastructure and sustainability, workers training, research and development). The hypothesis justifying this approach is based on the argument that the increasing payments to shareholders will decrease the available resources to invest (e.g. in R&D, human capital or other kinds of capital expenditures), and thus jeopardise future productivity growth. In other words, pay-outs crowd out real investments, resulting in a shift in corporate strategy from 'retain-and-reinvest' to 'downsize-and-distribute'.

Using a sample of 4,719 listed companies in 16 European countries[3] over the period 1992-2018, the study arrives at four main conclusions. First, shareholders' pay-outs increased from less than 20% of total income in 1992 to nearly 60% in 2018. Second, the ratios of CAPEX and R&D to net income decreased by 45 and 38 percentage points between 1992 and 2018 respectively. Third, countries like Belgium, the Netherlands, Portugal and Slovakia have larger shares of cash paid-out than Hungary and Poland.[4] Fourth, sectors such as food, and oil and gas, have the largest share of total pay-outs, compared with transport and construction.

Findings should be treated cautiously

These findings are highly questionable, in terms of the methodology and the measurement criteria used, the bias and reference to cherry-picking empirical studies, and the conclusions. On the conceptual side, the use of gross corporate payouts to measure the increase/decrease of short-termism may lead to false conclusions, given that shareholder value creation is not necessarily a short-term phenomenon.[5]

Perhaps a better payout measure would have been to use net shareholder payouts, which not only take into account capital movements between a firm and its shareholders, but also consider direct and indirect equity issuance by the firm (Skinner, 2008; Floyd *et al*., 2015; Fried

[2] The current consultation has attracted further criticism since the questionnaire it is based on is written in a way that allows answers that either reject sustainability or endorse the Commission's initiative (and the study). Given that few would do the former, one can only expect near total support for the latter (ECLE, 2020).

[3] Austria, Belgium, Croatia, Finland, France, Germany, Hungary, Italy, the Netherlands, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden and the United Kingdom.

[4] The country analysis performed for the period 2016-18.

[5] The shareholder value model is based on the present value of future cash flows, which reflects the future risk and opportunities to generating returns. It has therefore been widely used to illustrate the influence of environmental, social and governance factors on companies' risk-adjusted performance.

and Wang, 2019). Rather than considering only capital outflows, a more holistic approach would take capital inflows into account as well.[6]

A new study found that, after accounting large equity issuances by EU listed corporations, net shareholder payouts are relatively modest, leaving ample resources for investment (Fried and Wang, 2020). For the period 1992-2019, results show no evidence of excessive pay-outs through dividends or repurchases among EU listed corporations. This is because equity issuance was consistently higher than repurchases and net shareholder pay-outs were about half of total net income.[7] In other words, findings rebut the proposition that companies are neglecting their responsibilities towards sustainability in pursuit of short-term profits.

An interesting observation that the study prepared for the EU Commission fails to consider is that the distributed funds (from the company to shareholders) can be re-invested back into the company, or re-deployed in other listed companies with cutting-edge research and sustainable investment projects. Thus, higher returns for shareholders incentivise both retail and institutional investors to invest more, and consequently strengthen the equity base of companies (Roe, 2018).

Other aspects could have been taken into account that may significantly impact the findings. For example, the extremely low interest rate regime that most countries have experienced during recent years may have incentivised companies not to accumulate cash but instead to pay it out to the shareholders, or use it to repurchase/buyback their shares (Elgouacem and Zago, 2020). Also, the various crises that took place over the examined period (i.e. banking crises in Finland and Sweden, dot-com crisis, global financial crisis, European debt crisis) may have forced companies to take a short-term approach in their decisions and business strategies, with a focus on realising short-term capital gains (CFA, 2020).

Last but not least, the study provides insufficient information about the selection and the composition of the companies used, and their variation in terms of size, ownership type, corporate and business model.[8] Moreover, the cross-country analysis has not taken into account national differences in terms of company law and taxation, for example.[9] The inclusion of UK companies in the sample – a country that has left the EU – may also have biased

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[6] Regarding the investment indicators employed by the study, the use of CAPEX and R&D investments neglects those investments realised indirectly through mergers and acquisitions (M&A) (Bianchi and Milič, 2020). Moreover, the heterogeneous classification and disclosure of R&D investments across the EU may hinder the accuracy/quality of such measures (EC, 2020).

[7] In particular, among smaller firms the net shareholder pay-out was negative.

[8] Substantial discrepancies occur among different types of companies. For example, growth companies should have a higher proportion of R&D investments than value companies, while cooperatives or mutual companies have different governance structures and aims other than maximising profit. Regarding corporate governance models, Nordic companies are characterised by a more active governance role played by major shareholders (and stronger shareholder rights), while UK companies have a more dispersed governance mode.

[9] Although shareholders receive their financial return in the form of capital gains as well as dividends/share buybacks, the national tax treatment between capital gains and dividends varies substantially across EU member states. This means that some countries may favour dividends over capital gains. See, for example, the rankings of European countries in the Financial Complexity Index (TMF, 2018).

conclusions that are intended to form the basis of reforms exclusively in the EU27. In summary, several robustness checks could have been performed in order to confirm the validity of the findings.

The way forward

What is missing from the debate on directors' duties and sustainable corporate governance is the link with the Capital Markets Union (CMU) project and the objective to promote market finance. Today, EU companies rely on bank finance for 70% of their external financing, and often do not consider alternative external sources – which is certainly the case for small and mid-sized companies. This puts them at a competitive disadvantage with other regions, where market finance is abundantly available and allows start-ups to grow much faster. More market finance is a necessary alternative to bank-based finance, also from a financial stability perspective, and the EU Commission is busily engaged in ensuring that this is available.

Ideas that undermine the attractiveness of capital markets and aim to limit shareholder pay and reduce shareholder disclosure should be avoided. The polarity of short- versus long-termism is also misguided from a capital markets perspective. Companies seek short-term capital on the basis of long-term business plans. Investors are remunerated for risk taking, via dividends (which are in most countries heavily taxed, and often taxed twice when they cross borders). Limiting disclosure hampers the translation of information into prices (Fishman and Hagerty, 1989; Bond and Goldstein, 2012; Chung *et al*., 2016),[10] and reduces the attractiveness of market finance (Diamond and Verrecchia, 1991; Goldstein and Yang, 2017).

The Commission's commitment to further sustainability is laudable, and there is broad support for many of its initiatives that would help investors pursue sustainability. However, the current initiative on sustainable corporate governance is premised on a study that should be treated cautiously, especially when forming the basis for legislative action. Investors are not enemies of sustainability and as such should not be prevented from exercising real influence over companies. On the contrary, investors are the very people driving companies to consider all foreseeable risks, including those arising from climate change.[11]

To conclude, the study prepared for the European Commission assesses the root causes of short-termism in corporate governance from a very narrow perspective. Thus, it offers only one piece of the puzzle. In order to understand what drives short-termism, and whether or not EU listed companies are becoming more short-termist, a holistic approach is required.

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[10] On the one hand, disclosure can help mitigate information asymmetry between the firm and investors, and thus enhance price efficiency. On the other hand, disclosure can crowd out incentives of (potential) investors to acquire and produce new information (Gao and Liang, 2013; Goldstein and Yang, 2019), resulting in prices being less informative. Therefore, whether less disclosure hampers revelatory price efficiency or not is an ongoing empirical question.

[11] For example, companies engaged in environmentally damaging activities like oil or gas exploration should not be shielded from investor influence and left to do what they like with their cash. Instead, they should be subject to investor pressure in order to adopt a sustainable business plan that will attract further investments (cash paid out to investors is more likely to be reinvested in a company that promises a sustainable business than if it were saved).

In allowing companies and investors to make well-informed decisions long term, more information should become available short term – not the opposite. The Commission is engaged in revising the non-financial reporting requirements, and in implementing a taxonomy on sustainability risks. But more is needed at the EU level, such as: EU-wide norms and supervision of the audit profession; abolition of double withholding taxes on dividends; linking of executive remuneration to long-term sustainable targets; and the promotion of employee share ownership, among other measures.

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